

THIRD
EDITION

INTERNATIONAL BUSINESS LAW AND THE LEGAL ENVIRONMENT

A Transactional Approach

LARRY A. DIMATTEO



ROUTLEDGE

INTERNATIONAL BUSINESS LAW AND THE LEGAL ENVIRONMENT

International Business Law and the Legal Environment provides business students with a strong understanding of the legal principles that govern doing business internationally. Not merely about compliance, this book emphasizes how to use the law to create value and competitive advantage.

DiMatteo's transactional approach walks students through key business transactions—from import and export, contracts, and finance to countertrade, dispute resolution, licensing, and more—giving them both context and demonstrating real world application. This new edition also includes:

- New material on comparative contract and sales law, European private law, joint ventures, and collaborative alliances.
- A new part on foreign direct investment that includes a chapter on emerging markets.
- New chapters on privacy law and environmental concerns.
- Greater coverage of the World Trade Organization.
- “Case highlights” and court opinions, featuring edited court transcripts which expose students to actual legal reasoning and an understanding of underlying legal principles. These decisions are drawn from a broad range of countries, offering a truly international look at the subject.

Students of business law and international business courses will find DiMatteo's clear writing style easy to follow. A companion web site includes an instructor's manual, PowerPoints, and other tools to provide additional support for students and instructors.

Larry A. DiMatteo is the Huber Hurst Professor of Contract Law and Legal Studies at the University of Florida, USA. He is the author of over 80 books, articles, and book chapters. His research spans several areas of international business law including international contract, intellectual property, and sales laws.

This is an excellent source for students, academics, and practitioners alike interested in legal, ethical, and strategic issues in international business transactions. The author carries out a detailed analysis of important pieces of legislation, and provides a number of useful examples of different types of transactions.

Douglas Cumming, *York University, Canada*

Professor DiMatteo's text provides a well-organized, comprehensive tour of international business law. The up-to-date text is sufficiently detailed for the advanced student, but works equally well as an introduction to numerous topics in international law. Clearly written, the text provides both an overview of international business issues and strategies, as well as detailed summaries and highlights of international agreements. The instructor has a wealth of exceptionally detailed case studies and questions to explore with students. An internationally recognized expert in international contract, Professor DiMatteo has included information on the rise of China in global trade, including the attendant economic and ethical implications. Legal issues involving sustainability, including environmental ethics, climate change, and human rights raise some of the most pressing issues of our times for students.

Stephanie M. Greene, *Boston College, USA*

In a globalized world, success of any market player depends on adhering to the complex market rules. DiMatteo's textbook provides a helpful guide. Offering a comprehensive overview of international business transactions through the assessment of applicable theories, supported with practical examples and relevant judicial decisions, this text would be of particular use to both students and practitioners.

Pavel Repeuski, *Leeds Beckett University, UK*

DiMatteo advances an original approach to the relationship between international law and business. The textbook provides an authoritative account of the rules in an accessible and user-friendly structure to ensure that chapters are easy to navigate and key information can be readily broken down and retained. It is a valuable resource for educators and researchers alike with an interest in international business law.

T. Leigh Anenson, *University of Maryland, USA*

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Larry A. DiMatteo

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PREFACE TO THE THIRD EDITION

It has been said that all business now is international business. Smaller and smaller companies, including “mom and pop” businesses, are actively involved in exporting and importing goods and services. The Internet, government assistance programs, low trade barriers, as well as dependable transport, financial, and payment structures have opened access to foreign markets and lowered the risks of doing business internationally. The continued outsourcing of manufacturing inputs (raw materials and component parts) and of services, such as contact centers has increased business opportunities and the growth of international trade. The information society and accelerated technological development have made technology transfers and intellectual property licensing a growing part of world GDP. This book examines the means and practices developed in law and business to facilitate transborder trade and mitigate the risks of doing business internationally.

Legal, International, Transactional, and Practical Perspectives

Creating a “generalist” book on international business law seems an exceptional challenge because there is no single body of international business law as such. International business law is at most a compilation of different national systems. This book deals with this abundance of law through its transactional orientation. The text presents international business transactions with an emphasis on rules and practice. It is the author’s belief that it is these practical legal aspects of international business that are most relevant to today’s business and law students.

This transactional approach is the book’s distinctive characteristic. It draws from a broad variety of law, economic, and sociological sources, and above all it deals with international business transactions in the context of their real settings. This grounding of the legal aspects of international business is evident in the numerous practical bits of information that are not a reflection of law, but are related to law. The practices and techniques discussed are directed at fully utilizing the facilitative nature of law and are directed at avoiding the regulatory side of law, such as litigation, corruption, and violations of laws and regulations.

Use of the case method is retained with the utilization of sizable excerpts that expose the student to the court’s actual legal reasoning. The case selection avoids the American-only perspective as the cases are drawn from a variety of legal systems. Each case is followed by a synopsis highlighting the main points of each case. These “Case Highlights” distill the key legal points of each case for easier student understanding.

The selection of a variety of laws, regulations, case decisions, and principles and practices from numerous countries and international instruments provides a truly “international perspective” on doing business internationally. Again, the book makes a point of using judicial opinions from different countries, in both common law and civil law systems, and refers to legislation and practices from many parts of the world.

As noted above, the book is much more than a recitation on black letter law. It takes a more practical approach to international business law, focusing on a great range of information taken from business practice, providing material which is of use to legal and business practitioners (or students aiming to practice). This more technical approach equips students with the practical skills of negotiating an international sales contract and drafting the

supporting documents. To this end, the book provides students with a plentiful amount of practical examples of decided cases and disputes, checklists, and practice notes. The book is interested in how the law impacts business decisions and strategy. In that way, it possesses a major legal focus, yet also adds a managerial and contract-based focus. The subtitle, *A Transactional Approach*, is captured by some 178 “Figures” or capsules that provide additional commentaries, legal forms, checklists, practical examples, and legal analyses. These Figures come in three types: *Comparative Law*, *Doing Business Internationally*, and *Focus on Transactions*.

The Global Marketplace

The international marketplace offers great opportunity for domestic enterprises seeking to expand. It is also a place where the risks of loss are somewhat unique in character. Accordingly, the American businessperson must become an astute manager of international business risk in order to minimize the chances of financial loss. This book will illuminate the risks of doing business internationally and at the same time provide tools for their minimization. The legal issues relevant to international business transactions can be seen as a due diligence checklist. The sophisticated international entrepreneur directly addresses the legal issues discussed in this book before transacting international business. The tremendous expansion of international business is a testament to the fact that the legal issues in international business transactions are easily discernible. Furthermore, the real world often provides solutions to the risks associated with those issues. The trend is likely to continue with an increasingly greater percentage of American gross national product related to international business dealings. This trend began at the end of World War II with the establishment of the World Bank, International Monetary Fund, United Nations, and the evolution of the General Agreement on Tariffs and Trade (GATT). The trend continued to accelerate with the adoption of the North American Free Trade Agreement (NAFTA), the deepening of the European Union (EU), and the establishment of the World Trade Organization (WTO). It continued to accelerate with the opening of new markets occasioned by the fall of Communism, the transition of China from a Communist planned economy to a market economy beginning in the 1980s and culminating with its 2001 accession to membership in the WTO, as well as the explosion of international e-commerce. As such, small to large-sized companies will have to develop an “international business strategy” in order to stay competitive. This book provides an introduction to the legal issues relating to international business transactions in order to better equip the reader in formulating such a strategy.

Law as Risk Management

The major theme of this book is that businesses can “go international” without incurring a great deal of risk if the businessperson understands the legal mechanisms that have developed to minimize, and in many cases eliminate, such risks. The nature of the free trade era is that small and medium-sized companies, along with large companies, may and should enter the international marketplace. The aim of this book is to clearly explain how business is conducted internationally, with a strong emphasis on the exporting–importing of goods and the licensing of intellectual property, and how the law is used as a facilitator, not an obstacle, to doing business internationally. What distinguishes this textbook from the other textbooks in the field, as noted above, is that it provides a transactional-practical focused approach to the topic of international business law. It provides the necessary legal material but always in the context of real world transactions.

The perspective and presentation of the materials in the book move beyond complying with the “law,” to using the law to create value and competitive advantage. That is, international business law should be applied proactively to encourage international business transactions by being used creatively to keep parties from breaching contracts, resolving disputes amicably, and to preserving the contracting parties’ relationship. This perspective necessitates teaching lawyers and business managers the basics of international business law as a vital part in doing business and minimizing the unique risks of transborder transactions. This is especially true for small and medium-sized businesses.

Coverage

The book retains its “transactional” focus, but is now more comprehensive in its expanded coverage of more “macro” matters such as international trade law. Six new chapters have been added: Chapter 7 on free trade agreements; Chapter 8 on doing business in the European Union; Chapter 9 on doing business in China; Chapter 10 on comparative legal systems; Chapter 17 on agency and distribution; and Chapter 20 on foreign direct investment. All the other chapters have been updated with expanded coverage, especially in Chapter 6 on national import and export regulation and Chapter 21 on international e-commerce. The idea for added coverage of the EU and China is based upon their status as two of the three largest economies in the world, with the United States being the other one. They are also representative studies of doing business in the developed world (EU) and with emerging economies. China was chosen as the major economy in the BRIC (Brazil, Russia, India, and China) bloc of major emerging economies. Given the size of the Chinese economy it can be said that China has an “emerged” economy. But, despite its size, the Chinese economy still has internal structural problems and will need to mature and become more sophisticated. Chapter 9 will focus on both the benefits and pitfalls of doing business in China. Thus, the earlier editions’ focus on transactions-based coverage (exporting–importing; licensing; sales of services; e-commerce) is now complemented with substantial coverage of the legal environment of international business.

The *new* edition provides additional materials on contracting law with an emphasis on comparative contract and sales law and European private law. The book is divided into seven parts: Part I: Legal Environment of International Business; Part II: Trade Regulation; Part III: Doing Business in the European Union and China; Part IV: Comparative Legal Systems, Contract, and Sales Law; Part V: Exporting, Importing, and Trade Finance; Part VI: Licensing and Intellectual Property Rights; and Part VII: Foreign Direct Investment and E-Commerce.

Other Revisions to the Third Edition

The Third Edition is filled with too many instances of updating and new materials to list here. However, below is a list of the expanded coverage and new subjects that represent some of the more important changes:

Part I: Legal Environment of International Business

- Chapter 1: Consignment sales
- Chapter 1: List of the myths of the risks of doing business internationally
- Chapter 1: Government export assistance programs
- Chapter 2: Foreign Corrupt Practices Act and the Siemens Case
- Chapter 2: At the end of the chapter a lengthy case study (“Choosing Values: Public–Private Relationships in a Global Economy”) is presented involving an American company that has a manufacturing plant in a less developed country. The case study deals with numerous issues of law and ethics, and serves a number of purposes. Areas covered in the case study include: application of ethical schools of thought; environmental ethics; short-termism; sustainability; corruption; third-party relationships; issues related to joint venturing; strategic decision-making; stakeholder analysis; and corporate social responsibility.
- Chapter 4: New *lex mercatoria*
- Chapter 4: Principle of fair and equitable decision-making in arbitration
- Chapter 4: Commercial arbitration in East Asia
- Chapter 4: Negotiating an arbitration clause
- Chapter 4: Choosing an arbitrator
- Chapter 4: Ad hoc versus institutional arbitration
- Chapter 4: UNCITRAL Model Rules of Arbitration
- Chapter 4: Choice of law in international arbitration

- Chapter 4: Challenging arbitration awards
- Chapter 4: NAFTA arbitration

Part II: Trade Regulation

- Chapter 5: Expanded coverage of WTO
- Chapter 6: Harmonized tariff schedule (HTS)
- Chapter 6: Export licensing, export-processing zones, bonded warehouses
- Chapter 6: Sanitary and phytosanitary standards
- Chapter 6: Importation of genetically manufactured foods
- Chapter 6: Import licensing and Customs and Border Protection's automated system
- Chapter 6: "Special" Section 301
- Chapter 6: Marking requirements
- Chapter 6: Forced or indentured product information
- *New Chapter 7: Free trade agreements*
 - NAFTA
 - Korea–United States FTA (KORUS)
 - Central America–Dominican Republic FTA (CAFTA-DR)
 - Transatlantic Trade and Investment Partnership (T-TIP)
 - Trans-Pacific Partnership (TPP)
 - Free trade zones

Part III: Doing Business in the European Union and China

- *New Chapter 8: European Union*
 - History of EU and EU institutions
 - General principles of EU law
 - "Four Freedoms"
 - Sources of EU Law
 - EU law-making
 - Treaty of Lisbon
 - Eurozone
 - EU Charter of Fundamental Rights
 - Importing goods into EU
 - EU competition (antitrust) law
- *New Chapter 9: Emerging Economies: China*
 - BRIC countries
 - Language and culture
 - Pillars of the Chinese economic system
 - Role of the Chinese Communist Party
 - Negotiating in China
 - Chinese legal system
 - Modern Chinese law
 - Joint venturing in China
 - Franchise law in China
 - Problem of corruption
 - Protecting IPR
 - Doing business in Hong Kong

Part IV: Comparative Legal Systems, Contract, and Sales Law

- *New Chapter 10: Comparative Legal Systems*
 - Comparative law
 - Civil law tradition
 - Common law tradition
 - Chinese legal tradition
 - Islamic legal system
 - Hindu legal tradition
 - Canadian legal system
 - Mixed jurisdictions (Scotland and South Africa)
 - Transnational law
- Chapter 11: Common European Sales Law (CESL)
- Chapter 11: Consumer contract law
- Chapter 12: CISG in American courts

Part V: Exporting, Importing, and Trade Finance

- Chapter 13: Carriage conventions
- Chapter 13: Hamburg Rules
- Chapter 14: Methods of payment
- Chapter 14: Import certifications
- Chapter 14: Labelling requirements
- Chapter 14: *INCOTERMS 2010*
- Chapter 14: Bearer instruments
- Chapter 14: Electronic bills of lading
- Chapter 15: UCP 600
- Chapter 15: Society for Worldwide Interbank Financial Telecommunication (SWIFT)
- Chapter 15: International Standard Banking Practice (ISBP)
- Chapter 15: Real-time digital payments
- Chapter 15: Bitcoins and virtual currencies
- Chapter 15: Export–Import Bank (Eximbank)
- Chapter 16: Growth in sales and services
- Chapter 16: General Agreement on Trade in Services (GATS)
- *New Chapter 17: Hiring Agents and Distributors*
 - Commercial agents and agency law
 - Indonesia case study
 - Termination of the agency relationship
 - Just-in-Time and “Just-in-Case” supply chain
 - Distribution agreements
 - Importance of post-contract obligations

Part VI: Licensing and Intellectual Property Rights

- Chapter 18: World Intellectual Property Organization (WIPO)
- Chapter 18: Protecting IPR
- Chapter 18: Developing an international IPR strategy
- Chapter 19: Brand Protection Units
- Chapter 19: License writing problem

Part VII: Foreign Direct Investment and E-Commerce

- *New Chapter 20: Foreign Direct Investment*
 - Methods of investing
 - Greenfield investing
 - Bilateral Investment Treaties (BITs)
 - Strategic joint venturing
 - Trends in FDI
 - International Centre for Settlement of Investment Disputes
 - Competition law
- Chapter 21: Legal issues relating to the Internet
- Chapter 21: EU Directive on Data Privacy
- Chapter 21: Types of e-commerce
- Chapter 21: Methods of payment
- Chapter 21: Internet sales and small businesses
- Chapter 21: Minimizing Internet fraud
- Chapter 21: Korea–U.S. FTA and e-commerce
- Chapter 21: UNCITRAL Model Law on Electronic Commerce
- Chapter 21: UN Convention on the Use of Electronic Communications in International Contracts
- Chapter 21: Bolero Project

Special Features

Managerial Perspective

Throughout the book capsules and materials will be provided to illustrate the law of international business transactions *as practiced*. A variety of methods will be utilized to provide the student with a real world perspective. These methods include case studies, checklists, forms, tables, and summaries.

Text Boxes

Learning the terminology of international business is an important part of any international business law course. Text boxes provide definitions of key legal and nonlegal terminology, as well as additional information on the material covered in the text.

Case Highlights

At the end of each case, instead of asking a set of generic questions, a summation of “case highlights” are provided. These capsules list principles of law, concepts, and business practices presented in the case. Some of the highlights summarize the reasons why the case was inserted into the textbook. Other highlights alert the student to the fact that most legal disputes involve multiple issues. Many of these “external” highlights are examined elsewhere in the textbook. The intent of the “highlights capsules” is to make sure the reader clearly understands the key issues presented by the case. The instructor may also use these as a starting point for a more in-depth discussion of the multiple issues of the case.

Chapter Summaries and Key Terms

A list of key terms and concepts covered in the chapter is provided, and new to this edition, chapter summaries are located at the end of each chapter.

Ethics Coverage

As well as expanded coverage of ethics in Chapter 2, ethical issues are raised throughout the book, some explicitly and others implicitly can be mined by instructors wanting to discuss ethical issues that arise in various contexts. These contexts include the ethics of negotiations, disclosure of information, dealing with foreign governments, corruption, and the divergence between home country and host country laws. The student will be encouraged to form a mind-set in which ethical behavior will become an inherent part of their approach to international business.

International and Foreign Sources

The text reflects an earnest attempt to expose the student to a sampling of foreign and international laws. National laws from approximately two-dozen countries are referenced and used for purposes of illustration. There are numerous references throughout the text to a number of primary sources, such as American law, Chinese law, Russian law, EU law, and the law of individual European countries. The reader may refer to the endnotes for the proper citations. The use of national law serves to illuminate the typical issues found in international business transactions.

Style and Structure

A premium has been placed upon readability by the use of clear narrative, carefully edited case summaries and articles, and concise use of tangential materials. Also, in the spirit of the practical-managerial focus of the book, more in-depth insight is offered in certain areas so that the student is exposed not only to *why* a given rule of law has evolved, but also *how* it is applied in practice. The chapter coverage allows for the use of the chapters as individual modules or as blocks of chapter. The first seven chapters can be viewed as foundational in that they provide the legal environment of international business, including: international business risks, international business ethics, strategies for doing business internationally, international dispute resolution, national and international trade regulation, and international contract law. Chapters 8 and 9 are essentially case studies relating to the EU and China. They are stand-alone chapters that can be assigned anywhere in the course syllabus. Chapters 10 through 12 review different legal systems, national contract laws, and international sales embodied in the UN Convention on Contracts for the International Sale of Goods (CISG). Chapters 13 through 17 focus upon the legalities of transporting goods, exporting–importing, international trade finance relating to the sale of goods, and the hiring and sale of services. Chapters 18 and 19 pertain to the important area of the protection of intellectual property rights, as well as technology transfer and the international licensing of intellectual property rights. Finally, Chapters 20 and 21 provides coverage of foreign direct investment and the ever-evolving area of international e-commerce.

End of Chapter Problems

Each chapter concludes with problems appropriate for classroom discussion.

Internet Exercises and Other Internet Sources

A number of Internet exercises are provided throughout the book. These provide important web sites that students can use for reference or to answer a question or project posed. These projects can be used in individual or group assignments. In addition, at the end of each chapter are important Internet addresses that can be used for extended study and research projects.

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ACRONYMS

Agreement on Technical Barriers to Trade (TBT)
Agreement on the Application of Sanitary and Phytosanitary Measures (SPS)
Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)
Agreement on Trade-Related Investment Measures (TRIMs)
Alien Tort Claims Act (ATCA)
American Arbitration Association (AAA)
American Institute of Marine Underwriters (AIMU)
American Law Institute (ALI)
Anti-Cybersquatting Consumer Protection Act (ACPA)
Asia-Pacific Economic Cooperation (APEC)
Automated Export System (AES)
Bilateral Investment Treaties (BITs)
Brazil, Russia, India, and China (BRIC)
British Pounds Sterling (GBP)
Business Software Alliance (BSA)
Business-to-Business (B2B)
Business-to-Consumer (B2C)
Carriage of Goods by Sea Act (COGSA)
Central America–Dominican Republic FTA (CAFTA-DR)
China International Economic and Trade Arbitration Commission (CIETAC)
Chinese Contract Law (CCL)
Comité Maritime International (CMI)
Common European Sales Law (CESL)
Convention on Contracts for the International Sale of Goods (CISG)
Customary Freight Unit (CFU)
Department of Commerce (DOC)
Directorates Generals (DG) (EU)
Dispute Resolution Understanding (DSU)
Dispute Settlement Body (DSB)
Economic Espionage Act of 1996 (EEA) (US)
Electronic Data Interchange (EDI)
European Central Bank (ECB)
European Court of Human Rights (ECHR)
European Court of Justice (ECJ)
European Patent Convention (EPC)
European Union (EU)
Export Administration Regulations (EAR)

ACRONYMS

Export Control Classification Number (ECCN)
Export-Import Bank (Eximbank)
Export Management Company (EMC)
Export Trading Company (ETC)
Federal Trade Commission (FTC) (US)
Federal Trademark Dilution Act (FTDA)
Foreign Corporation Insurance Agency (FCIA)
Foreign Corrupt Practices Act (FCPA)
Foreign Direct Investment (FDI)
Foreign or Free Trade Zones (FTZ)
Foreign Sovereign Immunities Act (FSIA)
Free Trade Agreement (FTA)
General Agreement on Tariffs and Trade (GATT)
General Agreement on Trade in Services (GATS)
General Usage for International Digitally Ensured Commerce (GUIDEC)
Generalized System of (Tariff) Preferences (GSP)
Genetically Modified Organisms (GMOs)
German Civil Code or Bürgerliches Gesetzbuch (BGB)
Gross Domestic Product (GDP)
Harmonized Tariff Schedule (HTS)
Institute of London Underwriters (ILU)
Intellectual Property Rights (IPR)
International Accounting Standards (IAS)
International Bar Association (IBA)
International Centre for Settlement of Investment Disputes (ICSID)
International Chamber of Commerce (ICC)
International Institute for the Unification of Private Law (UNIDROIT)
International Labour Organization (ILO)
International Monetary Fund (IMF)
International Organization for Standardization (ISO)
International Organization of Securities Commissions (IOSCO)
International Patent Searching Authorities (ISA)
International Standard Banking Practice (ISBP)
International Standby Practices (ISP 98)
International Trade Commission (ITC)
Just-in-Time Contracting (JIT)
Korea–U.S. Free Trade Agreement (KORUS FTA)
Less-Developed Countries (LDCs)
Measure Equivalent to a Quantitative Restriction (MEQR)
Members of the European Parliament (MEPs)
Ministry of Foreign Trade and Economic Cooperation (MOFTEC) (China)
Multilateral Investment Guarantee Agency (MIGA)
Multimodal Transport Operators (MTOs)
Mutual Recognition Agreement (MRA)
Nongovernmental Organizations (NGOs)
Nontariff Barriers (NTBs)
North American Free Trade Agreement (NAFTA)
Organisation for Economic Co-operation and Development (OECD)
Overseas Private Insurance Corporation (OPIC)

ACRONYMS

Pacific Bridge Initiative (PBI)
Patent Cooperation Treaty (PCT)
Principles of European Contract Law (PECL)
Protection and Indemnity Policy (P & I)
Qualified Majority Voting (QMV) (EU)
Rules of Origin (ROO)
Sanitary and Phytosanitary Standards (SPS)
Shipper's Export Declaration (SED)
Small and Medium-Sized Enterprises (SMEs)
Small Business Administration (SBA)
Society for Worldwide Interbank Financial Telecommunication (SWIFT)
Special Administrative Region (SAR) (Hong Kong)
Special Drawing Rights (SDR)
Special Import Measures Act (SIMA) (Canada)
State-Owned Enterprises (SOEs) (China)
Supreme People's Court (SPC) (China)
Technical Barriers to Trade (TBT)
Trade and Investment Cooperation Agreement (TICA)
Trade and Investment Framework Agreement (TIFA)
Trans-Atlantic Business Dialogue (TABD)
Transatlantic Trade and Investment Partnership (T-TIP)
Trans-Pacific Partnership (TPP)
Treaty of the European Union (TEU) (Maastricht Treaty)
Treaty on the Functioning of the European Union (TFEU) (Treaty of Rome)
UNIDROIT Principles of International Commercial Contracts (PICC)
Uniform Commercial Code (UCC) (U.S.)
Uniform Computer Information Transactions Act (UCITA)
Uniform Customs and Practice for Documentary Credits (UCP 600)
Uniform Electronic Transactions Act (UETA)
United Nations Commission on International Trade Law (UNCITRAL)
United Nations Conference on Trade and Development (UNCTAD)
United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention)
United Nations Educational, Scientific, and Cultural Organization (UNESCO)
United States International Trade Commission (ITC)
United States Trade and Development Agency (USTDA)
United States Trade Representative (USTR)
U.S. Customs and Border Protection (CBP)
U.S. Trade Representative (USTR)
Value-Added Tax (VAT)
World Customs Organization (WCO)
World Intellectual Property Organization (WIPO)
World Trade Organization (WTO)

Part I

LEGAL ENVIRONMENT OF INTERNATIONAL BUSINESS



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INTRODUCTION TO INTERNATIONAL BUSINESS TRANSACTIONS

The purpose of this chapter is to briefly review some of the major topics and issues involved in international business transactions. The remaining chapters of the book will expand on the topics outlined in this chapter. The first part of Chapter 1 will highlight the tremendous growth in international business transactions and some of the causes behind this expansion. One factor that has aided the expansion of international trade is **the development of a supranational trade law**. Chapter 1 will therefore introduce the reader to the concept of customary international law.

We will examine the ways international business is transacted. The concepts of direct and indirect exporting, licensing, and foreign direct investment will be introduced. This discussion will provide a basic understanding of the perceived advantages and disadvantages of each method of transacting international business. These methods will be explored further in Chapter 3, along with hybrid ways of transacting business, such as **franchising** and joint venturing.

The second half of Chapter 1 will focus on the risks involved in international business transactions. The great opportunities presented by international trade do not come without risk. Some risks are the same as those in purely domestic transactions; others are more unique to the international business environment. First, we will analyze how companies evaluate such risks. Second, we will review the generic risks associated with international business transactions. These include risks associated with **cultural and language differences, currency risks, legal risks, and political risks**. Finally, we will briefly explore the tools that have been developed to minimize and manage such risks. We conclude by discussing strategies for managing international business risks, including the development of an export plan, use of intermediaries, and a form of international business known as **countertrade**.

Ultimately, **the goal of teaching international business law is to sensitize future entrepreneurs and lawyers to the risks of international business and the ways to manage such risks**: A savvy entrepreneur is adept at analyzing risk and knowledgeable about the techniques to minimize risk. While Chapter 1 will introduce the reader to the risks of international business transactions, the rest of the textbook will explore more fully how such risks are minimized in the areas of exporting, foreign direct investment, and intellectual property transfer.

Global and Regional Marketplace

The United States (U.S.) is the world's second largest exporter, with \$2.06 trillion in goods and services exports in 2011, according to the World Trade Organization's *World Trade Report 2012*. In 2011, the U.S. was the top exporter of services and second largest exporter of goods, behind China. For American companies, large or small, the potential for increased sales through international trade is high given that 95 percent of the world's consumers live outside of the U.S. So **if a company is selling only domestically, it is reaching just a small share of potential customers**. Exporting enables Small and medium-sized enterprises (SMEs) to diversify their portfolios and insulates **them against periods of slower growth in the domestic economy**. In a similar way, companies wanting to remain competitive need to extend their supply chains into foreign channels and by outsourcing some of their functions.

A number of factors have decreased the obstacles to international trade. The most important factor has been the success of the **World Trade Organization (WTO)**, and its predecessor the **General Agreement on Tariffs and**

Trade (GATT), in lowering tariffs and **nontariff barriers** to trade; the almost complete removal of the threat of **expropriation** as countries have moved to privatize their industries due to inefficiency; and the **proliferation of free trade agreements (FTAs)** that have further opened foreign markets. Other factors resulting in the growth of international trade include the **disintegration of the Soviet Union and Warsaw Pact**, the advent of “emerging economies,” dramatic advances in telecommunications and information technology, and the development of vibrant international capital markets in Europe and North America. The result of these watershed events has been the creation of global supply chains, as well as an economically and financially interdependent world.

Traditionally, **international trade (exporting–importing)** consisted of selling and transporting finished products from one country to another. However, in modern times these transborder movements **include the transformation of raw materials and the assembly of component parts as the products moved across national borders**. This fragmentation of the manufacturing process is known as the **global supply chain**, which includes numerous intermediary steps in the production of goods in different countries. For example, “in the manufacture of consumer electronics, intermediate inputs now account for close to three-quarters of imports from large emerging economies like Brazil and China.”¹ **This has resulted in the specialization of labor where different countries specialize on the parts of the supply chain where they are most competitive**. This is efficient and leads to economic growth, but also makes the **countries economically vulnerable when there is a downturn in the demand for the end products**.

The result has been significant increases in cross-border trade in manufacturing goods and services, international joint ventures, mergers, acquisitions, strategic alliances and affiliations, infrastructure projects, **privatization**, and international direct investment. The **liberalization of trade and investment rules has created a “world of opportunities” for the international entrepreneur**.² **The mobility of goods and services has allowed domestic companies to search the world for new markets to sell their products or to procure component parts used in the manufacture of their products**. The producer of goods and services, or the innovator of technology, can maximize profits with a global business strategy. This strategy encompasses **not only developing foreign markets for a company’s products but also outsourcing materials, labor, and component parts**. Even a company that takes a more isolated domestic sales strategy is likely to be affected by international developments.

One measure of globalization has been the tremendous growth in the international **trade in goods**. Table 1.1 and Table 1.2 show the values of the amount of goods imported and exported into the U.S. **The leading countries that import into the U.S. are China, Canada, and Mexico**. Despite the economic recession, the overall growth of imported goods from China grew 27 percent from 2010 to 2014. China exports represent 20 percent of all goods imported into the U.S. The Chinese legal and business environment will be reviewed in Chapter 9’s “Emerging Economies: China.” It is also interesting to note that the **two North American Free Trade Agreement (NAFTA) countries of Canada and Mexico combined are the U.S.’s largest trading partners, totaling 27 percent of all U.S. outstanding imports in 2014**. Table 1.2 shows by far that **Canada and Mexico are the largest purchasers of American goods, purchasing 34.4 percent of all U.S. exports in 2014**. This is partially due to the power of NAFTA, which removed trade barriers between the three NAFTA countries. NAFTA will be covered in Chapter 7’s coverage of FTAs.

Table 1.1 United States Imports of Goods (Billion USD)

Exporter	2010	2011	2012	2013	2014
Rest of World	1,966	2,262	2,333	2,328	2,408
China	382	417	444	460	486
Canada	279	319	327	336	352
Mexico	232	265	280	283	297
Japan	123	132	150	142	137
Germany	84	100	110	117	125
UK	50	52	56	54	55
South Korea	50	58	61	65	72

INTERNATIONAL BUSINESS TRANSACTIONS

Table 1.2 United States Exports of Goods (Billion USD and Annual Percent)

<i>Importer</i>	<i>2010</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>
Rest of World	1,277	1,480 (16.5%)	1,545 (4.4%)	1,578 (2%)	1,622 (2.8%)
Canada	248	281 (13%)	292 (4%)	300 (2%)	312 (3%)
Mexico	163	197 (21%)	216 (11%)	226 (5%)	240 (6%)
China	92	104 (13%)	110 (6%)	122 (10%)	124 (2%)
Japan	60	66 (9%)	70 (6%)	65 (−7%)	67 (3%)
UK	48	56 (16%)	55 (−2%)	47 (−14%)	54 (14%)
Germany	48	49 (2%)	48 (−2%)	47 (−2%)	54 (15%)
South Korea	39	43 (10%)	42 (−2%)	44 (5%)	72 (39%)

Table 1.3 Exports of Services (Billion USD)

<i>Exporter</i>	<i>2010</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>
USA	557	619	651	683	709
UK	267	296	292	297	334
Germany	247	274	270	291	272
France	196	235	216	237	264
China	162	176	191	205	223
Japan	141	145	145	148	162
Netherlands	118	138	133	149	157
India	117	139	146	151	155

These events depressed economic growth and increased investment risk, leading to a dramatic increase in capital outflows from Russia. Table 1.2 also shows the fluctuations from year to year due to macroeconomic forces. Japan has been fighting an economic recession for a long period of time, beginning in the 1990s, as shown by a modest 2.9 percent increase per year in the purchase of U.S. goods, including a negative 7 percent rate from 2012 to 2013.

Table 1.3 shows that the U.S. is the world's largest exporter of services, more than double that of the United Kingdom, which rates number two overall. U.S. exports of services have increased 27.3 percent from 2010 to 2014 despite economic times characterized by recession or slow growth in Europe and Japan. It is interesting to note that India has become the eighth largest exporter of services. Given the growth pattern over the five-year period from 2010 to 2014, India should soon overtake Japan in the export of services. During that span, India exports experienced 32.5 percent in growth compared to 15 percent for Japan. Chapter 16 will cover the area of sale of services.

Another measure of globalization is **foreign direct investment (FDI)**. FDI represents the capital investments made by companies in other countries. This includes the purchase of real estate, manufacturing plants, service and distribution centers, or foreign businesses. Between 1981 and 1985 total world FDI averaged \$98 billion per year. In 1997, FDI had reached \$440 billion. In 2014, **net FDI inflows (investment capital brought into a country minus investment outflows)** were \$348 billion for China and \$295 billion for the U.S. alone. See also Table 20.1 in Chapter 20 (FDI inflows, 2010–2013). The dramatic increase in world FDI has, much like trade, occurred mostly in the **three major regional trade areas of Europe, the Americas, and East Asia**. Clearly, political and economic stability are key factors in attracting FDI. An example of this is the case of the Russian Federation, which saw FDI inflows drop by 50 percent in 2014 when compared to the year before. This was due to the uncertainty caused by the Russian invasion of Crimea, followed by Western financial sanctions against Russia, the decline of oil prices (Russia's top export), and the subsequent collapse of the Russian currency (ruble). By the end of 2014, Russia was

suffering net investment outflows with net FDI in Russia recorded at –\$608 million in the third quarter 2014 and –\$3.4 billion in the fourth quarter 2014. **This demonstrates that national economies are highly interconnected and that national decisions can have dramatic consequences on FDI and a country's economic stability.**

Globalization is likely to expand both at the regional level and at the global level. The causes of this expected growth include the **advance of global telecommunications and the increased transferability of services and intellectual property.** The service and knowledge industries, such as entertainment, education, and health care, have benefited from the expansion of the GATT into the nonsale of goods area.

The growth in international trade is not always smooth as countries continue to bring actions against each other for violations of the WTO Agreements. Also, when there is a decline in demand, such as caused by the world recession beginning in 2008, **some countries responded by enacting additional trade restrictions.** While tariff rates remain at historical lows, an International Chamber of Commerce Report shows that the number of trade restrictions, known as **nontariff measures (NTMs)**, have increased since the 2008 financial crisis and most of them have come from the **developed economies (G-20).** **Many of these restrictions are anti-dumping measures to prevent the importation of goods being sold below their cost of production or the sale of lower-priced goods due to illegal government subsidies.**

G-20 Countries include Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russian Federation, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, United States, and the European Union as a whole.

In response, the WTO hosted the **Ninth Ministerial Conference in Bali in 2013** (the first such Conference since the establishment of the WTO in 1995). The success of the Bali Conference was especially important due to the failure of the Doha Round of negotiations in 2001, which was unsuccessful due to a major conflict between the developed and less-developed countries (LDCs). The Bali Conference focused on improving market access for LDCs, facilitation of trade, and new rules for the exporting of agricultural goods. The end result was a **Trade Facilitation Agreement (TFA)** that **aims to reduce, mostly bureaucratic barriers, to the flow of products through global supply chains.** The TFA aims at **streamlining customs and border procedures and infrastructure communications.** Many of these changes will have to be done by the LDCs since it is much more difficult to import goods into these countries than into developed countries. However, the **ultimate goal is greater access to foreign markets for LDCs' exports referred to as "duty free and quota free access."** Major questions remain as to what countries will ratify the TFA and where the funding will come from to make the border improvements.

Law of International Business Transactions

International law generally refers to the **historically developed transnational rules and norms that national courts use to regulate three primary relationships:** (1) **the relationship between two nations,** (2) **the relationship between a nation and an individual,** and (3) **the relationship between persons or entities from different countries.** This book is primarily concerned with the person-to-person relationship between two parties transacting business across national borders. The first two types of relationships will be reviewed, at times, because of their effect upon private business relationships. Thus, the regulations promulgated by the WTO will be studied in Chapter 5 because of their direct impact on the export and import of goods, services, and intellectual property rights.

There are numerous sources of international business law. **Article 38 of the Statute of the International Court of Justice**³ lists the sources of international law. In order of superiority they are: (1) **international conventions and treaties,** (2) **international custom or general practice,** (3) **general principles of law recognized by civilized nations,** and (4) **judicial decisions and scholarly writings.** These are the same sources of law often used by private parties in international litigation or arbitration proceedings.

The term **convention** is used in connection with multilateral agreements, as opposed to bilateral arrangements. The Vienna Convention on the Law of Treaties defines a **treaty** as “an international agreement between States and governed by international law.” Under U.S. law a treaty becomes federal law and is binding on federal, state, and local governments.

The **primary source of law in international business transactions** is the **private contract** entered into by the business parties. The contract will be the primary source of law in case of a dispute. At times, however, the contract may fail to provide a solution either because it does not deal with the issue in dispute or because the parties interpret the contract differently. It is said that “**no written contract is ever complete; even the most carefully drafted document rests on volumes of assumptions that cannot be explicitly expressed.**”⁴ This quote illustrates that a substantial core of any international business transaction is nonlegal in nature. **Businesspersons prefer the language of business and are often unconcerned with the legal language of the formal contract document.**

Despite this informal attitude, the language of business has been “codified” into legally recognizable custom and trade usage. This transformation is a tradition that dates back to the medieval **lex mercatoria**.⁵ The **lex mercatoria, or law of merchants, provides the mechanism in which courts and arbitral tribunals recognize day-to-day trade usage and business practices as customary international law.** The latter half of the twentieth century saw a broad expansion of international practices, codes, and rules emanating from public and private organizations. This transformation has resulted in a radical expansion of international business law.

The original **lex mercatoria** (Latin for “merchant law”) is the body of commercial law used by merchants throughout Europe during the medieval period. It evolved as a system of custom and best practices, which were enforced through a system of merchant courts along the main trade routes. In modern international commercial disputes, arbitrators often apply **lex mercatoria principles.**

The reality of trade liberalization and the **rapid expansion of exporting in services and licensing,** combined with the technological enhancement of business relationships, have increased the number of international conventions and supranational responses to globalization. **Businesspersons and lawyers should incorporate these conventions and standards in international business transactions because such “neutral” (nonnational) sources are a good way of overcoming cultural, language, and legal differences in cross-border transactions.** In the long term, **international legal unification and harmonization will reduce transaction costs relating to international contracting.**

Most international business disputes stem from poorly written contracts or the parties’ failure to recognize key substantive issues. Given the universal nature of business transactions and the globalization of the marketplace, **contractual failures attributable to inherent linguistic and cultural differences have significantly diminished, but when they do occur, they can lead to a high level of contract damages.** Another cause of legal disputes is the **existence of fundamental differences in national rules relating to the interpretation of contracts.** Thus, a primary way to understand the legal risk of international business transactions is to research cases and arbitral decisions dealing with key issues.

Customary International Law

Businesspersons can avoid misunderstandings by following standard practices, custom, and trade usage to minimize the risks of legal disputes. **These secondary sources of international business law can be divided into two general groups.** The first includes **international conventions or regional initiatives aimed at harmonizing rules relating to cross-border transactions.** Examples include the Hague Rules⁶ on the liability of international carriers of goods by sea and the WTO’s Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

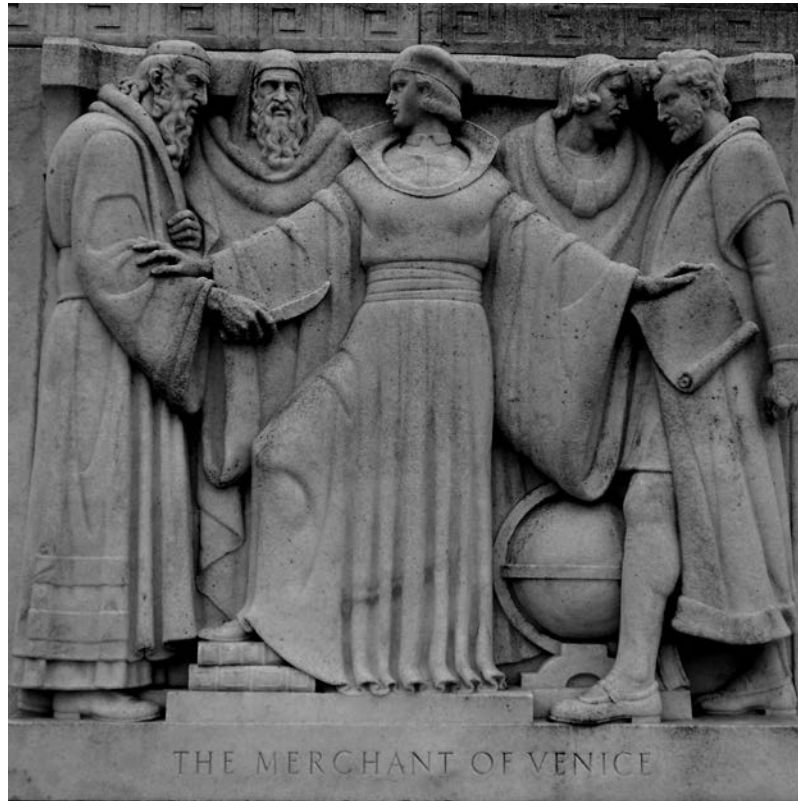


Image 1.1 Merchant of Venice.

Source: Smallbones, WikiCommons.

Regional efforts generally revolve around major free trade areas such as NAFTA and the European Union (EU), and also include broader-based institutions such as the Organisation for Economic Cooperation and Development (OECD).

The other secondary source of international law, the *lex mercatoria* or customary international law, has developed to bridge language, cultural, and legal differences between businesspersons throughout the world. The materials produced by the International Chamber of Commerce (ICC) illustrate the evolution of the *lex mercatoria*. The ICC was created in 1919 to promote free trade and private enterprise and to represent business interests at the international level. Members include national councils from more than sixty countries. Headquartered in Paris, France, the ICC is a nongovernmental organization that works to promote world trade, harmonize trade practices, and provide practical services to businesspersons. These services include the International Court of Arbitration in Paris, the Centre for Maritime Cooperation in London, the Counterfeiting Intelligence Bureau in London, and the Institute of International Business Law and Practice in Paris. The ICC's UCP 600 (Uniform Customs and Practices for Documentary Credits)⁷ and its INCOTERMS 2010 manual (of trade terms) are examples of international trade customs that have risen to near-universal acceptance in the international banking and business communities.

Businesspersons doing business internationally require a firm understanding of the substantive laws of the countries in which they intend to transact business. All countries have immutable or mandatory rules that vary in type and content. For example, a clearly written, principal-friendly termination clause in an agency agreement will

not survive the **evergreen laws** found in a number of European countries. **An evergreen provision is a statutory preemption of the termination and commission clauses of a private agency contract.** Therefore, **disclaimer of liability clauses enforceable in the U.S. would not be enforceable under EU law.** Evergreen laws will be discussed in Chapter 17's coverage of agency and distribution contracts.

The Written Contract

A clear and properly written contract remains the international entrepreneur's best protection in minimizing the risks of doing international business. However, the **United Nations Convention on Contracts for the International Sale of Goods (CISG)**⁸ states that **written agreements are not required and a contract may be proved by "any means including witness testimony."** In practice, many business transactions are characterized by a high degree of informality. As an English court noted: "One has to bear in mind that commercial men and women do not look at things from the lawyer's point of view."⁹ Despite the informal nature of business contracting and the common use of standard forms, it is likely that sophisticated businesspersons base their agreements on at least a **semi-formal writing.** **This seems especially prudent given the obstacles of foreign languages and cultures, including differences in negotiating styles.** These factors, and the potential difficulty and expense of obtaining a legal remedy in a foreign country, justify the additional time spent researching legal issues and writing a contract. Negotiating a written contract will often highlight the latent differences of language and law while there is time to reconcile differences before the execution of the contract. Differences in foreign legal systems and national contract laws will be examined in Chapters 10 and 11. The CISG, as the major international sales contracts law, will be reviewed in Chapter 12.

Behind every business transaction is the fear of nonperformance requiring one of the parties to seek a legal remedy. Understanding international contract dispute resolution is important in order to negotiate and draft an effective contract. Just as prenuptial agreements are written in anticipation of a possible divorce, **contracts should be written in anticipation of possible contract disputes.** What can international businesspersons write into their contracts to make dispute resolution less likely to be needed? What can they write into the contract that would make **dispute resolution less painful or costly** in the event it is necessary? What can be included in the contract to **increase the chances** for success in a dispute resolution? These questions will be addressed in Chapter 4 on "International Commercial Dispute Resolution."

Scope of International Business Transactions

All business transactions involve considerable risk. The essence of being a businessperson or entrepreneur is a willingness to confront loss in the search for profits. **Profit seeking or risk taking underscores the capitalistic, free-market system.** The most consistently successful entrepreneurs are those who take steps to avoid or minimize risk. Risk-aversion techniques and strategies have been developed to provide stability and security to international business transactions. **Risk minimization** is essential for both domestic transactions and those that cross national boundaries, but there are profound differences in approach between international and domestic business transactions.

The **"basket of risks"** associated with an international transaction is different in many ways from that of a purely domestic transaction. Businesses' efforts to minimize risk differ, too. Many international risk management devices, although longstanding, are likely to be unfamiliar to the U.S. businessperson on his or her initial foray into exporting, licensing, or foreign direct investment. International dealings are further complicated by the fact that the basket of risks to be confronted is constantly fluctuating, depending on the type of business entity, the type of good or service being sold, the country of the other party, the country of performance, and the means of transportation.

At the broadest level of analysis, the **risk characteristics will depend largely on the type of transaction.** Transactions are categorized under four general groupings: **exporting–importing (sale of goods), sale of services (consulting, distribution, transportation, marketing, sales), licensing (technology, intellectual property transfer and licensing), and foreign direct investment (foreign operations).** This classification is overly simplified because many

transactions display characteristics of two or more categories. Hybrid forms of doing business like franchising and joint venturing will be discussed in Chapters 3 (“Strategies for International Business”) and Chapter 20 (“Foreign Direct Investment”). **The franchise transaction generally involves the contractual transfer or licensing of a bundle of intellectual property rights, know-how, trade secrets, and, in some cases, the sale of goods or services.** **The joint venture** is most closely associated with foreign direct investment, but may also involve the transfer of goods, services, technology, and capital. A third hybrid form, discussed later in this chapter, is countertrade, which is a form of exporting used to overcome the risks of currency inconvertibility, local participation requirements, and restrictions against the repatriation of capital (profits). Countertrade can also be used within the framework of a joint venture or technology transfer.

Direct and Indirect Exporting

The most popular method of transacting business internationally remains the exporting of goods, which can be divided into indirect and direct exporting. Direct exporting is when a company exports goods on its own account—dealing directly with a foreign customer and sending its goods to that customer in exchange for payment. **Indirect exporting** involves the use of an intermediary firm to facilitate the exporting of a company’s goods. **The principal advantage of indirect exporting for a smaller company is that it provides a way to penetrate foreign markets without the complexities, costs, and risks of direct exporting.** A company may contact **commission agents or buying agents** who find foreign firms that want to purchase a company’s products. Such agents seek to obtain the desired items at the lowest possible price and are paid a commission by their foreign clients. In some cases, the agents may be representing foreign government agencies or quasi-governmental firms empowered to locate and purchase desired goods.

Indirect exporting often involves the use of an **export management company (EMC) or export trading company (ETC).** An EMC, in essence, acts as the export department for one or several producers of goods or services. As a private business, **it solicits and transacts business** in the name of the producers it represents or in its own name for a commission, salary, or retainer plus commission. **Some EMCs offer immediate payment for products either by arranging financing or by directly purchasing products for resale.** The best EMCs know their products and markets very well and usually have well-established networks of foreign distributors already in place. This immediate access to foreign markets is one of the principal reasons for using an EMC. **One disadvantage** to using an EMC is that **a manufacturer loses control over foreign sales.** Control is an important issue for a manufacturer concerned with maintaining their product and company image in foreign markets.

Export Management Companies (EMCs) develop personalized services promoting their client’s products to international buyers and distributors. The main reason for a manufacturer using an EMC is that an EMC can provide immediate access to foreign markets. The process of directly developing a relationship with foreign buyers can be lengthy and costly.

A manufacturer that wants to minimize its involvement in exporting goods can simply **sell its goods to a domestic ETC.** An ETC takes title to the product and exports for its own account. **For the manufacturer the transaction is essentially a domestic sale.**

Export Trading Company (ETC) is an independent distributor. As opposed to representing a given manufacturer in a foreign market, the ETC determines what U.S. products are desired in a given market and then works with U.S. producers to satisfy the demand.

Some special ETCs are organized and operated by producers. These types of ETCs can be organized along multiple- or single-industry lines and can represent producers of competing products. The U.S. Congress has encouraged the growth of ETCs through the enactment of the *Export Trading Company Act of 1982*, which allows banks to make equity investments in commercial ventures that qualify as ETCs. In addition, the *Export-Import Bank (Eximbank) of the United States* is allowed to make working capital guarantees to U.S. exporters. The *Office of Export Trading Company Affairs (OETCA)*, within the U.S. Department of Commerce, promotes the formation and use of U.S. export intermediaries and issues export trade certificates that provide limited immunity from U.S. antitrust laws.

An indirect exporting method similar to using an ETC is selling goods to an export agent or remarketer. Export agents or remarketers purchase products directly from the manufacturer, packing and marking the products according to their own specifications. The remarketers then sell overseas through their contacts in their own names and assume all account risks. The U.S. manufacturer relinquishes control over the marketing and promotion of its product, which may have an adverse effect on future sales efforts abroad. Finally, a hybrid type of exporting is **consignment**. Consignment involves delivery of merchandise to a foreign party, whereby the exporter retains title to the goods that it transfers only when the consignment company sells the goods. The consignee gets paid a commission upon the sale of the goods and the remittance of payment to the exporter. Retaining ownership of the goods until they are sold provides protection to the exporter, but the exporter carries the financial burden and risk of nonpayment and having unsold goods returned. See Chapter 17 on “Agency and Distribution.”

Direct Exporting

The most common form of international trade is direct exporting or importing. A company new to direct exporting generally treats export sales no differently than domestic sales, using existing personnel and organizational structures. To be a successful exporter often requires the separation of international from domestic business including focusing marketing efforts through a separate international sales department. Regardless of how a company organizes for exporting, it should ensure that the structure facilitates the marketer’s job. Experience shows that a company’s success in foreign markets depends less on the attributes of its products than on its marketing methods. However, it is important to note that small businesses, without an internal marketing department, have become successful exporters. See Figure 1.1 *Doing Business Internationally*: “Myths of the Risks of Exporting by Small Companies.”

- MYTH 1: EXPORTING IS TOO RISKY:** Different international markets have different levels of risks. Risks are identifiable, and there are numerous low-cost ways of minimizing such risks. See Chapter 7 (“Free Trade Agreements”), Chapter 13 (“Transport of Goods”), Chapter 14 (“Documentary Transactions”), Chapter 15 (“International Trade Finance”), and Chapter 17 (“Hiring Agents and Distributors”).
- MYTH 2: GETTING PAID IS DIFFICULT:** Trade finance and global banking have evolved to the point where buying and selling things internationally is routine, safe, and efficient. Reliable payment collection methods are numerous and include letters of credit through banks, credit cards, and online payments. See Chapter 15 (“International Trade Finance”).
- MYTH 3: EXPORTING IS TOO COMPLICATED:** Most exporting requires minimal paperwork. Researching markets and finding buyers can in many instances be done from your computer using free or low-cost information. Third-party export facilitators, such as e-commerce platforms, can remove much of the complexity and risk.
- MYTH 4: STAYING DOMESTIC IS A SOUND STRATEGY:** U.S. businesses are involved in or affected by international business, whether they realize it or not. Small and medium-size companies need an international strategy that includes diversifying markets.
- MYTH 5: COMPANIES CAN BE TOO SMALL TO GO INTERNATIONAL:** No company is too small to go global. In fact, nearly 30 percent of all U.S. exporters in 2005 had fewer than 19 employees, and many had fewer than five.
- MYTH 6: AMERICAN PRODUCTS ARE LESS MARKETABLE ABROAD:** If your product or service sells well in the United States, there’s a good chance an overseas market can be found. For some markets, you may have to make some modifications because of cultural or regulatory differences.
- MYTH 7: I AM NOT LIKELY TO SUCCEED BECAUSE OF A LACK OF FOREIGN LANGUAGE SKILLS:** The English language will take you a very long way, and help is readily available for situations in which interpreters and translators are necessary. Some basic knowledge of cultural and business etiquette can be learned and is very helpful, despite language difficulties.

Figure 1.1 *Doing Business Internationally*: Myths of the Risks of Exporting by Small Companies.

Once a company has been organized to handle exporting, it must select the proper channel of distribution in each market. These channels include sales representatives, agents, distributors, retailers, and end users. A **foreign sales representative** is the equivalent of a **manufacturer's representative in its home country**. The representative uses the company's product literature and samples to present the product to potential buyers; a representative often handles many complementary lines from different manufacturers. The sales representative usually works on a commission basis, assumes no risk or responsibility, and is under contract for a definite period of time. The contract defines territory, terms of sale, method of compensation, reasons and procedures for terminating the agreement, and other details. In contrast, a **foreign agent** normally has authority to make commitments on behalf of the firm he or she represents. Any contract should state whether the representative or agent does or does not have legal authority to bind the firm to contracts.

The **foreign distributor** is a merchant who purchases merchandise from an exporter, resells it at a profit, and generally provides after-sales support and service. The distributor usually carries an inventory of products and spare parts and maintains adequate facilities and personnel for normal servicing operations. An exporter must screen carefully all potential representatives, agents, or distributors. The following information should be obtained and reviewed: (1) current status and history, including background of principal officers; (2) personnel and other resources (salespeople, warehouse and service facilities); (3) sales territory covered; (4) current sales volume; (5) typical customer profiles; (6) methods of introducing new products into the sales territory; (7) names and addresses of domestic firms it currently represents; (8) trade and bank references; and (9) the foreign company's view of the in-country market potential for the exporter's products. This information is not only useful in gauging how much the representative knows about the exporter's industry, it is also valuable market research in its own right. Credit reports are available from commercial firms and from the Department of Commerce's *World Traders Data Report* program. To protect itself against possible conflicts of interest, the exporter should learn about other product lines that the foreign firm represents.

Evaluating Risks Through Market Research

To be successful, international entrepreneurs and exporters must assess foreign markets through market research. Exporters engage in market research primarily to identify their marketing opportunities and constraints and also to identify and find prospective customers. A company's market research should determine the largest foreign markets for its products and identify trends, outlook, conditions, practices, and competitors in those markets.

In conducting **primary market research**, a company collects data directly from the foreign marketplace through interviews, surveys, and other direct contact with representatives and potential buyers. Primary market research has the advantage of being tailored to a company's needs and answering specific questions, but it is time-consuming and expensive. Because of the expense of primary market research, most firms rely on secondary data sources (see Figure 1.2 *Focus on Transactions: "General Sources for Market Research"*). 1

Secondary market research is conducted in three basic ways. The first is by keeping abreast of world events that influence the international marketplace, watching for announcements of specific projects, or simply visiting foreign markets. The second is by analyzing trade and economic statistics. Trade statistics are generally compiled by product category and by country. U.S. government agencies compile statistics with information about shipments of products over specified periods of time; demographic and general economic statistics such as population size and makeup, per capita income, and production levels by industry can be important indicators of the market potential for a company's products. The third method of secondary market research is obtaining the advice of experts, including contacting experts at the Department of Commerce and other government agencies; attending seminars, workshops, and international trade shows; hiring an international trade and marketing consultant; talking with successful exporters of similar products; and contacting trade and industry association staff. 3

Working with secondary sources is less expensive and helps the company focus its marketing efforts. However, the most recent statistics for some countries may be more than two years old. Also, statistics on sale of services are often unavailable. Yet, even with these limitations, secondary research is a valuable and relatively easy first step for a company to take. See Figure 1.3 *Doing Business Internationally: "A Step-by-Step Approach to Market Research"*.

- **Business America.** This biweekly publication of the U.S. Department of Commerce contains country-by-country marketing reports, incisive economic analyses, worldwide trade leads, advance notice of planned exhibitions of U.S. products worldwide, and success stories of export marketing.
- **Commerce Business Daily (CBD).** Published daily, Monday through Friday, by the U.S. Department of Commerce, CBD lists government procurement invitations, contract awards, subcontracting leads, sales of surplus property, and foreign business opportunities as well as certain foreign government procurements.
- **Trade Information Center.** A comprehensive source for U.S. companies seeking information on federal programs and activities that support U.S. exports, including information on overseas markets and industry trends, the center maintains a computerized calendar of U.S. government-sponsored domestic and overseas trade events.
- **National Trade Data Bank (NTDB).** The NTDB contains export promotion and international trade data collected by 15 U.S. government agencies. Updated each month and released on CD-ROM, the data bank enables access to more than 100,000 documents. The NTDB contains the latest census data on U.S. imports and exports by commodity and country; the complete Central Intelligence Agency (CIA) World Factbook; the complete Foreign Traders Index, which contains more than 50,000 names and addresses of individuals and firms abroad interested in importing U.S. products; and many other data sources.
- **Small Business Administration (SBA).** The SBA markets research-related general resources.

Figure 1.2 **Focus on Transactions: General Sources for Market Research.**

(See also Internet Exercise Problem 7 for additional sources.)

1 Screen potential markets

Step 1. Obtain export statistics that indicate product exports to various countries. Foreign Trade Report: Monthly Exports and Imports (SITC Commodity by Country) (Department of Commerce) provide statistics on all U.S. exports and imports. Firms should also consult the Export Information System (XIS) Data Reports (SBA), or U.S. Industrial Outlook (Department of Commerce).

Step 2. Identify five to ten large and fast-growing markets for the firm's product. Examine them over the past three to five years. Has market growth been consistent year to year? Did import growth occur even during periods of economic recession? If not, did growth resume with economic recovery?

Step 3. Identify some smaller but fast-emerging markets that may provide ground-floor opportunities. If a market is just beginning to open up, there may be fewer competitors. Growth rates should be substantially higher in these countries to qualify as up-and-coming markets, given the lower starting point.

Step 4. Target three to five of the most statistically promising markets for further assessment. Consult with Department of Commerce district offices, business associates, freight forwarders, and others to help **refine targeted markets.**

2 Assess targeted markets

Step 1. **Examine trends** for company products as well as related products that could influence demand. Calculate overall consumption of the product and the amount accounted for by imports. Industry Sector Analyses (ISAs), alert reports, and country marketing plans, all from the Department of Commerce, give economic backgrounds

and market trends for each country. Demographic information (population, age, etc.) can be obtained from World Population (the Bureau of the Census) and Statistical Yearbook (United Nations).

Step 2. Ascertain the sources of competition, including the extent of domestic industry production and the countries of origin of the major competitors in each targeted market, by using ISAs and competitive assessments (all from the Department of Commerce). Look at each competitor's U.S. market share.

Step 3. Analyze factors affecting marketing and use of the product in each market, such as end user sectors, channels of distribution, cultural idiosyncrasies, and business practices. Again, ISAs are useful, as is the Comparison Shopping Service (CSS) offered by the Department of Commerce.

Step 4. Identify any foreign barriers (tariff or nontariff) to the product being imported into the country. Identify any U.S. barriers (such as export controls) affecting exports to the country. Country information kits produced by the Overseas Private Investment Corporation (OPIC) can be helpful.

Step 5. Identify any U.S. or foreign government incentives to promote exporting of the product or service.

3 Draw conclusions

After analyzing the data, the company may conclude that its marketing resources would be applied more effectively to a few countries. In general, efforts should be directed to fewer than ten markets if the company is new to exporting; one or two countries may be enough to start with. The company's internal resources should help determine its level of effort.

Figure 1.3 **Doing Business Internationally: A Step-by-Step Approach to Market Research.**

Source: National Trade Data Bank, a product of STAT-USA, U.S. Department of Commerce.

Risks of International Business Transactions

The numerous risks associated with international business transactions vary depending on the method of transaction, such as trade, licensing, or direct investment. They will also vary depending on what countries the business parties are located and in what country the transaction is to be performed. The country where a party is a citizen of, national is its home country. If a party is transacting business in a foreign country, then that country is referred to as the host country. This section will analyze four categories of international business risks: cultural and language, currency, legal, and political.

The types of risks that an international businessperson faces, and the methods utilized to minimize such risks, will vary from transaction to transaction depending on a number of variables. Two of the most fundamental variables, noted above, are the identity of the host country and the type of transaction. In general, the level of risk escalates in the three basic ways of conducting international business, from exporting–importing to licensing, and from licensing to foreign direct investment. We will investigate the particular types of risks involved in these areas

Table 1.4 Risks of Doing Business Internationally

Type of Risk	Description	Mitigation of Risks
Generic Risk: Method of Doing Business	Foreign Direct Investment (FDI) Riskier Than Licensing; Licensing Riskier than Exporting	There are numerous ways of mitigating risk depending on the method of business
Generic Risk: Foreign Country	Different Countries have Different Risk Characteristics	A risk assessment should be performed to determine a foreign country's political and economic stability
Generic Risk: Non-Delivery of Goods	Buyer Makes Payment, But Never Receives Goods	On-Account Transaction Documentary Collection Transaction Standby Letter of Credit
Generic Risk: Non-Payment (Exporter)	Seller Sends Goods, But Never Receives Payment	Cash in Advance Letter of Credit Retention of Title Consignment
Language Risk	Misunderstanding of Oral Communications and Written Contract	Translation Contract in Both Languages
Cultural Risks	Risk of Offending Other Party Different Negotiation Styles	Etiquette Building Trust
Currency Risks	Fluctuation, Convertibility, and Repatriation Risks	Payment in Own Currency Hedging Countertrade
Political Risks	Expropriation Change in Regulations ("creeping" expropriation)	Political Risk Insurance Bilateral Investment Treaties (BITs) Concession Agreement
Legal Risks	Differences in Law, Enforcement of Law, and Legal Remedies Enforceability of Judgments	Foreign Lawyer Contract Remedies Choice of Law Forum Selection Arbitration Clause (New York Convention)
Special Import Laws	Local Participation and Content Requirements Standards Termination Laws ("evergreen laws")	Market Selection Use of Independent Contractors
Transportation Risks	Damage of Goods in Transit and Misdelivery	Cargo Insurance Trade Term

of international business transactions. The importance of assessing **host country risk** is highlighted by a review of three comparative scenarios presented below. In each scenario, representatives of a U.S.-based company must weigh the risks of doing business in two countries using one of the three basic market entry strategies discussed above. The *italicized* words represent key concepts that will be defined and explored throughout the textbook. Using these three scenarios we can begin to understand the complexity of the risks involved in international business transactions. A successful international businessperson is sophisticated and able to recognize risks and take the appropriate precautions.

Risk in Developing Countries

The level of risk in transacting business in many developing countries is considerably higher than in developed countries. Some countries are marked by arbitrary government actions, excessive taxation, ineffective legal and dispute resolution systems, and a high degree of corruption. These countries find it difficult to interest foreign investment. Therefore, the best and possibly the only way to conduct business in these countries is by exporting. Some countries have passed laws to assure foreign investors and businesspersons by legally attempting to reduce the risks of doing business. Mexico passed the Foreign Investment Act of 1993 in order to attract and protect foreign investment. It opened large portions of the Mexican market to foreign ownership. In certain strategic economic industries, approval of the National Commission of Foreign Investments is needed for foreign ownership of greater than 49 percent, while some industries, such as oil, electricity, and railroads, remain reserved for Mexican nationals. The Foreign Investment Act provides expedited procedures to gain governmental approvals. For an extensive review of the risks of doing business in China, see Chapter 9.

Scenario 1: Sale of Goods to Nigeria and Canada

Nigeria has been rated at the top of the recent *Corruption Index* published by Transparency International, a nongovernmental organization (NGO). It may be difficult to undertake business dealings in Nigeria without being asked to give a bribe. To best understand the risks of doing business with such a country, it is prudent to order a *political risk report* from a professional risk assessment company. It is also advisable to contact the U.S. State Department for information. It is imperative to fully investigate the foreign party, including credit and reference checks. A strong *ethics compliance program* will need to be in place in order to prevent the giving of bribes in violation of the U.S. *Foreign Corrupt Practices Act*. Also, the Nigerian currency is not *convertible* to a hard currency like the U.S. dollar, European euro, or English pound. Payment in one of these

hard currencies is unlikely because of government restrictions against the *repatriation* of such currencies from the country. Thus, the risk of doing business, even in the relatively risk-free method of exporting, may be too great a problem in a place like Nigeria.

Any exporting to such a country needs to be supported by a *confirmed letter of credit* from a reputable international bank. The currency convertibility and repatriation problems could be overcome through a *countertrade* transaction in which goods are exchanged for each other or an export transaction is linked to an import transaction. Another device to eliminate the risk to a company is to find an *export trading company* willing to perform the transaction on its own account. Finally, the costs and feasibility of obtaining political and credit risk insurance

should be investigated. The *Overseas Private Investment Corporation* (OPIC), *Eximbank*, and the *Multilateral Investment Guarantee Agency* (MIGA) provide various types of insurance.

In contrast to exporting to Nigeria, exporting to Canada offers a low level of risk. *Country* and *currency risks* are minimal given that Canada is a stable, industrialized country and a member of the *North American Free Trade Agreement*

(NAFTA). Although currency fluctuations are possible, the Canadian dollar is freely convertible into the U.S. dollar. Currency fluctuation risk may be a concern in a long-term transaction, and both parties may manage that risk through a variety of *hedging* techniques. In a one-shot export transaction, the risk of a dramatic currency rate change is unlikely. The U.S. exporter can eliminate all currency risk simply by requiring payment in U.S. dollars.

Scenario 2: Licensing Technology to the People's Republic of China and France

The licensing of technology and the transfer of *intellectual property rights* presents the next level of risk in international business transactions. Any time a company discloses confidential information and trade secrets to a third party, there is always a risk that the information may be further disclosed to unauthorized parties. The problem is confounded when that disclosure is made in a foreign country that is not protective of intellectual property.

China has acceded to numerous intellectual property rights' conventions, such as the *Berne Convention*, but in the past the level of trademark, copyright, and patent infringement through piracy and counterfeiting has been relatively high. The cost and time of legal action to prevent the importation of illegal *gray market* goods has been the only effective countermeasure. It is hoped that Chinese membership in the *World Trade Organization* (WTO) will result in greater enforcement of intellectual property law. In the meantime, the *licensor* needs to negotiate a *transfer agreement* that includes contractual protections against the misuse of the licensed information. The problem remains whether such protections will be enforced. In order to reduce the

cost of enforcement and increase the likelihood of success, the licensor should consider alternative dispute resolution methods such as *mediation* and *arbitration*. It is also important for the licensor to understand that, unlike in the United States, the licensing agreement may not be a totally private affair. Lesser-developed countries, former communist countries, and China often require government approval and registration of licensing agreements. The contract is likely to be reviewed and pro-licensor clauses modified. Clauses most susceptible to revision include the *royalty*, *confidentiality*, *termination*, and *grant-back* clauses.

In contrast to China, France has an established record of intellectual property protection. It is important for the intellectual property owner to register its rights under the patent, copyright, and trademark laws of France before entering any transfer agreement. The license or transfer agreement is generally enforced as written under French law, but superseding *European Union Regulations* dealing with licensing of patents and intellectual property must be addressed, and certain provisions that are legal under U.S. laws may be illegal under EU *competition* (antitrust) *law*.

Scenario 3: Purchasing a Company in the Russian Federation and Germany

The most risky of all international business transactions is foreign direct investment, which can range from opening a branch office to purchasing an existing company or building a manufacturing facility. Foreign direct investment is risky primarily because it makes a company susceptible to a wide range of *host country laws*. These laws cover the areas of employment and labor, environmental, health and safety, product liability, and taxation. In considering foreign direct investment, the first decision is what type of legal vehicle should be chosen to operate the foreign enterprise. The most popular way of doing business is to establish an independent subsidiary under the laws of the host country.

In purchasing an existing company in Russia, the greatest risk is the uncertainty in the meaning and enforcement of commercial laws. Most of the current Western-styled laws were enacted following the fall of communism in 1991. Supporting jurisprudence (found in Western legal systems) has yet to be developed by the Russian courts; in fact, the widespread ineffectiveness of the Russian legal system has been well chronicled. Russia is a country where the use of a *joint venture* with an established Russian partner might be advantageous. A joint partner can share the risks and provide a portion of the capital or offer necessary government contacts and distribution systems. Joint ventures have to be approved or registered with government agencies, and failure to register can lead to severe negative

consequences such as the dissolution of the joint venture. How does the 2014 Russian invasion of Crimea and subsequent Western sanctions impact your decision? How would you mitigate the risks of political and economic stability in Russia in order to take advantage of investment opportunities due to a depressed Russian economy and the strength of the U.S. dollar? Note that U.S. development assistance, insurance, and lending programs have been frozen for investments in Russia.

In contrast, purchasing a company in Germany is much the same as buying a company in the United States. There is little likelihood of a government *expropriation* or ***nationalization*** in Germany. Germany's pro-worker labor laws, however, prohibit an acquiring firm from ignoring existing collective bargaining agreements. The employment-at-will doctrine of the United States allows an acquiring firm to downsize the workforce with little legal restraint, but in Germany employment is viewed as a *property right* that must be respected. Any substantial changes in the workforce, such as layoffs or plant closings, must be submitted to a *works council* made up of employees. Finally, the corporation laws in both Russia and Germany should be researched. The limited liability provided by the corporate entity is sacrosanct in U.S. law, but in foreign legal systems an attempt to *pierce the corporate veil* to hold a parent company or a joint venture partner liable is more likely to be successful.

Pricing Risks

For a first time exporter of goods it is vital to internalize all the additional costs of international trade within your price. **A domestic company cannot assume that the appropriate price of its goods in the domestic market is the appropriate price for a foreign market.** Depending on the type of transaction and the trade term inserted into the contract there will be a number of costs **unique to international sales** that will need to be incorporated into the price charged for the goods. Assume **you are an exporter of goods and enter into a documentary transaction** and **the trade**

term is **CIF (cost, insurance, and freight)** (see Chapter 14). In a documentary credit transaction, the exporter must obtain a list of documents. Some of these documents will cost money to obtain, such as an inspection certificate, standby letter of credit (see Chapter 15), and a certificate of origin. **The exporter also has to obtain an export license, meet all marking and labeling requirements, as well as any necessary product or marketing modifications needed to comply with the laws of the country of import.** The CIF trade term allocates to the exporter the costs of shipping the goods to a seaport in the exporter's country, the loading of the ship, and the freight and insurance expenses to the foreign port of destination. **If the seller is being paid in a foreign currency, it may want to buy a hedge or insurance against a detrimental currency fluctuation, such as a currency option.** The cost of obtaining the option needs to be incorporated into the price. These costs need to be internalized in the price if the exporter wants to maintain its profit margins. A checklist of questions to be considered in setting the price of exports includes:

- Do the products need to be modified or be tailored to the foreign market?
- What products and product prices are the best fits for a given market?
- Have you determined the time and costs of each phase of the Export Plan?
- Have you determined the costs unique to international sales, such as the costs of insurance, obtaining documentation, and compliance with customs regulations?
- Have you researched the need to obtain the services of experts, such as freight forwarders, custom brokers, and foreign legal counsel?
- Have you determined how to provide warranty and after-sales services?
- Have you allotted sufficient time to implement the plan and to determine its long-term profitability?
- Do the products and accompanying marketing materials need to be modified due to different standards and requirements in the country of import? Do advertising materials have to be adjusted to conform to the cultural and legal differences found in foreign markets?
- Is a U.S. export license required?
- How do you plan on distributing the goods in the foreign country?
- Have you allocated enough resources to help ensure success?
- Who will have the authority to modify the plan to improve its effectiveness?

If the good being exported is complete and ready to sell to the ultimate purchaser, the exporter must determine whether the price for the product (with all the internalized costs) is marketable in the foreign country. **The price may make the product cost prohibitive in a country with a low per capita GDP.** The exporter would be left to decide not to export to that country, modify the product to make it less costly to produce, or license the right to produce the product to a company in the foreign country. **The foreign company may be able to produce the product more cheaply because of the lower costs of labor, regulatory compliance, and materials in its country. The exporter would then collect royalties as the licensor.**

The importer also has **additional expenses in an international transaction** that need to be **factored in** determining the actual costs of the goods. Using the above scenario (documentary credit transaction and CIF trade term), the buyer is obligated to pay the costs of obtaining a letter of credit from a commercial bank, of unloading the ship, warehousing costs at the port, clearing goods through customs, paying import tariffs, and transporting the goods from the port to another location. If the payment is in the exporter's currency, the costs of buying a currency option, future, or forward contract needs to be factored into the costs.

Legal Risks

One of the primary risks in all international business transactions is the application and enforcement of foreign laws. Host country (foreign) laws may include restrictions on currency conversion and repatriation of profits. If a company is deemed to be doing business in a foreign country, then it will become amenable to the legal jurisdiction of that country's court system. Companies that establish a presence in a foreign country must also be concerned

with local employment laws. Many countries impose severe restrictions on the termination of employees or agents, such as requiring lengthy notice requirements and substantial severance payments. Other host country laws that should be examined include labeling, marketing, and advertising laws; income and sales tax laws; environmental laws; product and consumer liability laws; health and safety laws; and antitrust or competition laws. In order to decrease the uncertainty due to the risks of foreign laws, the United States has entered into **bilateral investment treaties (BITs)** (see Chapter 7) with many foreign countries. These treaties provide the basic legal framework for a company investing in a foreign country. They generally address issues of convertibility of currency, repatriation of profits, compensation for expropriation, protection of intellectual property, and nondiscriminatory treatment of foreign investors.

Because of differences in language, culture, and legal systems, the intentions of parties in an international transaction may not be easily discernible from their contract. Therefore, it is imperative, more so than in a purely domestic undertaking, for the parties to express carefully intended rights and obligations in a written contract. At the time of execution, it is important that the parties, with the assistance of their lawyers, review each contract clause to make sure all parties understand them.

Of course, such a model approach to contract review is not often practical. For example, in the typical export transaction there is no single form that both parties read and sign. The parties simply exchange their own forms in order to conclude a contract—one form being the offer and the other the acceptance. Nonetheless, each party should take the time to carefully review the terms and conditions found in the other party's form before entering into the contract. This is especially important if it is the first transaction between the contracting parties. It is also important, especially in large transactions with a corporation or partnership, to verify the other party's authority to bind his company to a contract.

Often the quality of a contract is evident not in what it says but in what it fails to say, and an international contract may be the product of "studied ambiguity." Vagueness or ambiguity in contractual language is employed in order to achieve the illusion of agreement. The roots of contract ambiguity come from two sources: (1) the parties negotiating the contract and (2) those charged with drafting the contract. A common scenario is that the principals negotiate the general framework for an agreement and then turn the task of writing the language of the agreement over to their attorneys. Such brief negotiations increase the risk of ambiguity inherent in interpersonal communication, especially within a cross-cultural context. A key issue for international businesspersons is to determine at what stage they should enlist the services of a lawyer.

Businesspersons often do not use lawyers in the negotiation stage of contracting, viewing them as obstacles to, rather than facilitators of, agreement. The businessperson-to-businessperson, face-to-face exchange is a paradigm of how business is done, while lawyers are relegated to the task of writing the formal documents. In international contracting, the businessperson, especially one new to international dealings, would be well advised to enlist an astute **international transactional lawyer**, along with foreign counsel. The issue of trust aside, international dealings should be evidenced by clearly written and highly negotiated agreements.

Legal systems can differ in substantive laws, procedures, remedies, and levels of enforcement. Although the fundamental legal concepts dealing with business transactions are similar in the civil, common, and socialist legal systems, idiosyncratic differences in the rules can result in unexpected legal liabilities. For example, in Germany the civil law system recognizes the notion of *nachfrist* notice¹⁰ in the area of sale of goods. In U.S. law, a party has the right to strictly enforce the delivery date stated in the contract and can summarily reject a request for more time. In contrast, the civil law concept of *nachfrist* notice dictates that such dates should not be strictly enforced. A request for additional time should be granted unless the nonbreaching party can give a commercially viable reason for not granting the requested extension.

Suppose that a U.S. businessperson enters a contract with a German supplier for delivery of goods on June 1. On May 25 the German supplier sends a letter requesting an extension for delivery to June 30. Under U.S. law, the buyer may simply reject the request and hold the German supplier in breach of contract if the goods are not delivered on June 1. In fact, the U.S. buyer in this instance responds by saying that the contract provides for delivery on June 1 and any delivery beyond that date will not be accepted. On June 1 the goods are not delivered and the U.S. buyer obtains substituted goods from another supplier. On June 30 goods are received from the

German supplier. The U.S. buyer responds by rejecting the “late” delivery. Under *nachfrist* notice, it is the U.S. buyer and not the German supplier who has breached the contract. Because the U.S. buyer failed to give a commercially viable reason for not granting the additional time, the civil law automatically awards the time extension. Therefore, the delivery on June 30 was timely and the German can now sue for full contract damages under German law.

In other instances, the rules of law may be similar, but the procedures and remedies available may differ significantly. In some countries the cultural abhorrence to litigation results in difficulty finding adequate legal counsel and restricted discovery options.¹¹ The United States’ Federal Rules of Civil Procedure provide a liberal set of rules that allow for full discovery of the other party. Such sweeping discovery techniques may not be available in other countries. Also, the remedies available to the plaintiff may be of a different order. The U.S. notions of treble (triple) and punitive damages are not found in most foreign legal systems, and the U.S. and common law views that prefer to give monetary damages are not found in civil law countries. In civil law the plaintiff is allowed the choice of suing for monetary damages or receiving an order of specific performance that forces the other party to honor the contract.

Finally, similarities in the substantive laws of a country may mask differences in the enforcement of those laws. This can be seen in the areas of intellectual property protection and corruption. A number of countries have ratified the primary international property rights conventions, such as the Paris and Berne Conventions, but have been lax in their enforcement. Lax enforcement has resulted in high levels of counterfeiting and piracy of trademarks, patents, and copyrights. All countries prohibit the bribing of government officials, but lack of enforcement in some countries has resulted in a culture where bribery has become common. Such an environment places limitations on U.S. businesspersons prohibited from making illegal payments to foreign officials under the Foreign Corrupt Practices Act.

A number of countries, especially in the developing world, have enacted laws specifically targeted to foreign investment and trade. Examples of such specialized host country laws include laws that protect host country agents and distributors of foreign products from termination without notice or payment. In some countries—notably within the European Union—a foreign exporter or manufacturer may not terminate its host country agent without paying statutorily determined indemnity compensation or damages in concordance with evergreen statutes. Evergreen statutes limit the ability of a principal or employer to discharge an employee or agent.

Some countries limit the amount of equity ownership that a foreign company may hold in a host country enterprise. These local participation requirements often result in the foreign company creating a partnership or joint venture with nationals of the host country. Because of the limited amount of hard currency in some countries, other laws restrict a foreign investor or exporter from withdrawing or repatriating their profits or royalties from the country.

Another common area of host country intervention is in the area of technology transfers. In some countries private licensing agreements must be registered and approved by the government. Pro-licensor clauses involving royalty payments, termination, and training may be rewritten to be more favorable to the licensee. These types of specialized host country laws need to be analyzed to determine their impact on a potential foreign investment, export transaction, or intellectual property transfer.

Language and Cultural Risk

In the past, a major obstacle to international business transactions involved the differences in language and the cultural backgrounds of the transacting parties. Language difficulties have diminished significantly due to the precipitous rise in foreign language proficiency. Nonetheless, even when dealing with a foreign counterpart who speaks English, it is important to understand that misunderstandings can still occur. One device to overcome language differences is to have the contract drawn in the languages of both parties. But the *Falcoal, Inc. v. Kurumu* case that follows illustrates that even this precaution may fail to overcome inconsistencies that may result from translation. The language problem in this case revolves around the pivotal issues of where the parties may sue under the contract’s forum selection clause and whether the U.S. court had **personal jurisdiction** over the foreign defendant.

Falcoal, Inc. v. Kurumu*660 F. Supp. 1536 (S.D. Tex. 1987)*

David Hittner, District Judge. Plaintiff Falcoal, Inc. is an American corporation having its principal place of business in Houston, Texas. Defendant Kurumu (TKI) is a commercial entity, owned and controlled by the Turkish government. TKI decided to import a portion of Turkey's coal supply. In an attempt to solicit bids, TKI issued a notice announcing a "sartname" ("terms and conditions"). This announcement was made in local Turkish-language publications. The sartname distributed by TKI was issued in Turkish and provided by its terms that any conflicts as to its terms would be settled by reference to the original Turkish language version. Falcoal submitted the bid that was ultimately accepted by TKI. Falcoal's bid was signed and submitted by its authorized agent, Zihni, a Turkish company. The negotiation of the contract took place entirely in Ankara, Turkey.

After the parties had agreed to the terms, Zihni prepared two copies of the contract, an English version and a Turkish version. Although the parties assert that they believed the content of the two versions to be identical, the English contract and the Turkish contract contain forum selection clauses, which directly contradict each other. The Turkish-language version provides that "the final jurisdiction for the settlement of any disputes, in the case of the PURCHASER [TKI] submitting a claim, lies within the jurisdiction of the Houston commercial courts and, in the case of the SUPPLIER [Falcoal] submitting a claim lies within the jurisdiction of the Ankara commercial courts." The English-language contract, by contrast, provides that any dispute "shall be finally settled in Houston and submitted to the jurisdiction of the Courts of the U.S.A. if the claim is put forward by Supplier [Falcoal] and in Ankara, Turkey, and submitted to the Turkish Courts if the claim is put forward by Buyer [TKI]."

Pursuant to the contract, Falcoal was to deliver 100,000 tons of coal to a shipper of TKI's choice. Falcoal agreed to post a performance bond in an amount equal to 10 percent of the contract price and, pursuant to this agreement, Citibank International-Ankara issued a performance bond in favor of TKI in the amount of \$400,000. This bond was secured by a letter of credit opened by Falcoal at Citibank International-Dallas. The contract further provided that, to secure payment for the coal, TKI was to open a letter of credit in New York forty-five days before shipment. TKI failed to open this letter of credit. When the coal was not shipped, TKI, without authorization, drew on Falcoal's performance bond. Falcoal subsequently

brought this suit against TKI, alleging breach of contract for failing to open the New York letter of credit in Falcoal's favor, conversion and fraud for wrongfully drawing on Falcoal's performance bond, and injury to Falcoal's business reputation. TKI has moved to dismiss, alleging lack of **subject matter jurisdiction** and lack of personal jurisdiction.

Subject Matter Jurisdiction

TKI asserts that this Court lacks subject matter jurisdiction because TKI, as an entity of the Turkish government, has sovereign immunity under the Foreign Sovereign Immunities Act of 1976 (FSIA), 28 U.S.C. § 1602 *et seq.* However, Falcoal contends that TKI waived sovereign immunity by agreeing to a forum selection clause and falls within the commercial exception of the FSIA. The waiver provision and commercial exception are found in section 1605(a):

Section 1605 (a) A foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case—

- 1 *in which the foreign state has waived its immunity either explicitly or by implication, notwithstanding any withdrawal of the waiver which the foreign state may purport to effect except in accordance with the terms of the waiver;*
- 2 *in which the action is based upon a commercial activity carried on in the United States by the foreign State; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States.*

This Court would find merit to Falcoal's "waiver" argument, were the English-version forum clause the only clause at issue. However, the Court cannot ignore the existence of the Turkish contract, whose forum clause provides for suit in Houston when TKI is the plaintiff. That contract expressly provides for suit *against* TKI in Turkey. Clearly, under the facts of this case where, as here, there are two contradictory forum

clauses and where the issue of which forum clause should control is vigorously contested, the English-language clause cannot be said to constitute a waiver of sovereign immunity.

The Court next reviews Falcoal's argument that TKI's actions place it within the exceptions to sovereign immunity set forth in section 1605(a)(2). Clearly this action is not one "based upon commercial activity carried on [by TKI] in the United States." The FSIA defines such commercial activity as activity "having substantial contact with the United States." The mere provision for payment in the United States, however, is not a "substantial contact" meeting the test for commercial activity under the FSIA. It remains for this Court to determine whether TKI's conduct falls within the third clause of section 1605(a)(2) as to whether the conduct alleged against TKI constitutes "an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere" which "causes a direct effect in the United States." At issue is the definition of "direct effect."

TKI asserts, and Falcoal has not shown otherwise, that it has had no contacts with the Texas forum, or in fact with the United States, other than its involvement in the contract which is the subject of this suit. That contract was solicited, negotiated, drafted, and executed in Turkey and in the Turkish language. The contract itself does not establish minimum contacts with the Texas forum. Nor does TKI's agreement to pay through a letter of credit in New York create personal jurisdiction. Thus, in the instant case the constitutional requirements for exercise of *in personam* jurisdiction are lacking.

In an effort to resolve the tension between 28 U.S.C. §1605(a)(2) and 28 U.S.C. § 1330(b), courts have taken two approaches. Some have held that an effect cannot reach the level of "direct" effects described in the statute and thus sovereign immunity cannot be overcome, unless the effect fulfills the "minimum contacts" requirement. Other courts have given "direct effect" its literal meaning and found such an effect when an American corporation has suffered a direct financial injury due to a foreign sovereign's conduct. This Court finds the latter approach to be most reasonable. The Court holds that the conduct of TKI in drawing on Falcoal's performance bond was an action, which caused a direct effect in the United States, and thus TKI cannot

claim sovereign immunity from this suit. Subject matter jurisdiction, therefore, exists.

Personal Jurisdiction

Constitutionally, this Court cannot exercise personal jurisdiction over TKI unless TKI has taken some action that may be construed as an expression of waiver or implied consent to the exercise of such jurisdiction. Falcoal contends that such an implied consent is found in the forum selection clause of the English-version contract. This Court could find waiver, however, only if it were found that the Turkish-language clause is unenforceable and the English version valid. The Court thus faced with the existence of two contradictory clauses, must look to the law of the appropriate forum to determine which clause to enforce. Because the contract was solicited, negotiated, and executed in Turkey, Turkish law must apply. Both parties agree that, were Texas law to apply, the existence of contradictory clauses would evidence a lack of meeting of the minds on the issue of forum for suit, and the clause should be dropped from both contracts. However, in the absence of a determination of similar Turkish law, the clauses cannot be eliminated from the contract. Although this Court finds that TKI has been divested of its sovereign immunity to this suit by its actions in Turkey having a direct effect in the United States and, thus, subject matter jurisdiction exists, the Court finds that it lacks personal jurisdiction over TKI. Motion to Dismiss is GRANTED.

Case Highlights

- importance of the forum selection clause in international contracts
- use of letters of credit and performance bonds to secure payments and performances
- defense of sovereign immunity, along with the waiver and "commercial activity" exceptions
- determining if a court has personal jurisdiction over the defendant through the "minimum contacts" or "direct effects" standards
- importance of determining the appropriate law to be applied
- importance of selecting the language that controls when more than one language contract is executed.

Business executives who hope to expand abroad should learn about the history, culture, and customs of the countries to be visited. Business manners and methods, religious customs, dietary practices, humor, and acceptable dress vary widely from country to country. For example, never touch the head of a Thai or pass an object over it—the head is considered sacred in Thailand. Avoid using triangular shapes in Hong Kong, Korea, and Taiwan—the

triangle is considered a negative shape. The number 7 is considered bad luck in Kenya and good luck in the Czech Republic, and it has magical connotations in Benin. The number 10 is bad luck in Korea, and 4 means death in Japan. Red is a positive color in Denmark, but it represents witchcraft and death in many African countries. A nod means “no” in Bulgaria, and shaking the head from side to side means “yes.” The “OK” sign commonly used in the United States means zero in France, is a symbol for money in Japan, and carries a vulgar connotation in Brazil.

Understanding and heeding cultural variables such as these is critical to success in international business and travel. Lack of familiarity with the business practices, social customs, and etiquette of a country can weaken a company’s position in the market and prevent it from accomplishing its objectives and ultimately lead to failure. Some of the cultural distinctions that U.S. firms face most often include differences in business styles, attitudes toward development of business relationships, attitudes toward punctuality, negotiating styles, gift-giving customs, greetings, significance of gestures, meanings of colors and numbers, and customs regarding titles. U.S. firms must pay close attention to different styles of doing business and the degree of importance placed on developing business relationships. In some countries business people have a very direct style, while in others they have a more subtle style and value a personal relationship more than most U.S. businesspersons. For example, in the Middle East, engaging in small talk before engaging in business is standard practice.

The U.S. businessperson must also consider foreign customs. For example, attitudes toward punctuality vary greatly from one culture to another and, if misunderstood, can cause confusion and misunderstanding. Romanians, Japanese, and Germans are very punctual, whereas people in many of the Latin countries have a more relaxed attitude toward time. The Japanese consider it rude to be late for a business meeting, but acceptable, even fashionable, to be late for a social occasion. In Guatemala, on the other hand, one might arrive any time from ten minutes early to 45 minutes late for a luncheon appointment.

Proper use of names and titles is often a source of confusion in international business relations. In many countries (including the United Kingdom, France, and Denmark), it is appropriate to use titles until use of first names is suggested. First names are seldom used when doing business in Germany. Visiting businesspeople should use the surname preceded by the title. Titles such as “Herr Direktor” are sometimes used to indicate prestige, status, and rank. In Thailand, people address one another by first names and reserve last names for very formal occasions and written communications. In Belgium it is important to address French-speaking business contacts as “Monsieur” or “Madame.”

Customs concerning gift giving are extremely important to understand. In some cultures gifts are expected, and failure to present them is considered an insult, whereas in other countries offering a gift is considered offensive. Business executives also need to know when to present gifts, where to present gifts, what type of gift to present, what color the gift should be, and how many to present. Gift giving is an important part of doing business in Japan, where gifts are usually exchanged at the first meeting. In sharp contrast, gifts are rarely exchanged in Germany and are usually considered inappropriate. Gift giving is not a normal custom in Belgium or the United Kingdom either, although in both countries flowers are a suitable gift when invited to someone’s home.

Customs concerning the exchange of business cards vary, too. Although this point seems of minor importance, observing a country’s card-giving customs is a key part of business protocol. In Japan, for example, the Western practice of accepting a business card and pocketing it immediately is considered rude. The proper approach is to carefully look at the card after accepting it, observe the title and organization, and acknowledge with a nod that the information has been digested, and perhaps make a relevant comment or ask a polite question. In addition, it is essential to understand the importance of rank in the other country, to know who the decision-makers are, to be familiar with the business style of the foreign company, and to understand the negotiating etiquette and nature of agreements in the country.

Another facet of international business concerns selling practices. Because cultures vary, there is no single code by which to conduct business. Certain business practices, however, transcend culture barriers: (1) answer requests promptly and clearly; (2) keep promises—a first order is particularly important because it shapes a customer’s image of a firm as a dependable or undependable supplier; (3) be polite, courteous, and friendly; and (4) personally sign all letters.

The importance of religious practices should not be underestimated; religious and cultural differences not only impact a foreign entrepreneur directly in the negotiation of a contract but also will subsequently impact employees and agents in the performance of the contract. The *Kern v. Dynalelectron Corp.* case that follows illustrates the challenges faced by an organization in conducting its business in a foreign country.

Kern v. Dynalelectron Corp.

577 F. Supp. 1196 (N.D. Tex. 1983)

Belew, District Judge. Wade Kern filed this religious-discrimination suit pursuant to Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e-2000e-17 (1976) against Dynalelectron Corporation. On August 17, 1978, Wade Kern entered into a written contract of employment with the Defendant, Dynalelectron Corporation, to perform duties as a helicopter pilot. The work to be performed in Saudi Arabia consisted of flying helicopters over crowds of Moslems making their pilgrimage along Muhammad's path to Mecca. Those pilots who were stationed at Jeddah would be required to fly into the holy area, Mecca. Saudi Arabian law, based upon the tenets of the Islamic religion, prohibits the entry of non-Moslems into the holy area, Mecca, under penalty of death. Thus, Dynalelectron, in accordance with its contract with Kawasaki, requires all pilots stationed at Jeddah to be (or become) Moslem. Had Wade Kern continued to work for Dynalelectron, he would have been based in Jeddah and, therefore, his conversion from Baptist to Moslem would have been required. Defendant later offered Kern a job as a member of the air crew, a position not requiring his conversion. However, Kern declined to take that job. Kern filed a sworn complaint with the Equal Employment Opportunity Commission alleging that he was denied an employment opportunity with Defendant due to its discrimination against him because of his religious beliefs.

One of the several ways in which the defendant can carry his burden is by establishing that the discrimination was not unlawful since religion may be a bona fide occupational qualification (B.F.O.Q.). The B.F.O.Q. defense is set forth in § 703(e) of Title VII:

Notwithstanding any other provision of this title it shall not be an unlawful employment practice for an employer to hire and employ employees on the basis of religion, sex, or national origin in those certain instances where religion, sex, or national origin is a bona fide occupational qualification reasonably necessary to the

normal operation of that particular business or enterprise.

The use of the word "necessary" in section 703(e) requires that we apply a business necessity test, not a business convenience test. There can be no question but that non-Moslem pilots stationed in Jeddah are not safe as compared to Moslem pilots. Therefore, Dynalelectron's discrimination against non-Moslems in general, and Wade Kern specifically, is not unlawful since to hire Moslems exclusively for this job "is a bona fide occupational qualification reasonably necessary to the normal operation of that particular business," § 703(e) of Title VII. Notwithstanding the religious discrimination in this case, the Court holds and finds that the B.F.O.Q. exception is properly applicable.

In *Fernandez v. Wynn Oil Co.*, 653 F.2d 1273 (9th Cir. 1981), a female plaintiff sued her employer for discriminatorily not promoting her because she was female. The job to which she would have been promoted required her to deal with South American businessmen who preferred not to do business with females. There, the Court stated that the mere fact that it was an international case did not distinguish it from other cases wherein it was held that mere customer preference would not justify the use of the B.F.O.Q. exception. The requirement that an individual be a Moslem to perform the duties of a helicopter pilot in certain portions of Saudi Arabia is a bona fide occupational qualification within the meaning of 42 U.S.C. § 2000e-2(e). Thus, Kern voluntarily and unilaterally rescinded his agreement to work for Defendant and thus breached his obligation under the contract.

Case Highlights

- A written employment contract in this case helped limit the employer's liability because it expressly stated the business necessity for conversion to Islam
- extraterritorial application of U.S. employment laws
- the Bona Fide Occupational Qualification (BFOQ) as a defense to an employment discrimination claim

- religion can be a BFOQ in some international business situations.

Some other tips for “Dealing with Cultural Factors” include: (1) Start with what you know. Try beginning with a business culture and system similar to your own. Canada and the United Kingdom are often good markets for beginners. (2) Be patient. Different cultures have different concepts of time. Few markets have a faster business pace than the United States; many are slower. (3) Take

time to develop personal relationships—especially with distributors or large-volume buyers. Remembering birthdays and other important events is a good intercultural business practice—be warm, welcoming, respectful, and thoughtful. (4) Learning a few words of the native language of your buyers or business associates will go a long way. They will appreciate the effort. (5) Hire a student intern in the foreign country to assist in preparing for discussions with customers, especially in contract negotiations in Japan, China, and countries in which Arabic is spoken.

Currency Risks

Currency risks are a concern in almost all business transactions that cross national borders. There are three separate risks that relate to currency and international business transactions: convertibility, repatriation, and currency rate fluctuation. A buyer and a seller in different countries rarely use the same currency. Payment is usually made in either the buyer’s or the seller’s currency or in a mutually agreed-on currency that is foreign to both parties. Currency **convertibility** is the issue of whether one currency is convertible into another currency. Other than the world’s hard currencies, such as the U.S. dollar, English pound, European euro, Swiss francs, Japanese yen, and more recently the Chinese yuan, most national currencies are not easily convertible. Hard currency is sometimes referred to as convertible currency.

Unlike countries with hard currency, countries with soft currency do not possess sizeable exchange reserves and surpluses in their balance of payments. Russian rubles cannot be converted to U.S. dollars. That leaves the U.S. businessperson with limited options—reinvest the rubles in the Russian economy or find an alternate means of payment, such as countertrade (see Figure 1.4 on “Countertrade”). An exporter or investor can overcome any convertibility problem by requiring payment in a hard currency.

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Countertrade frequently is confused with the concept of barter. Barter is an exchange of goods effectuated without the use of currency. Countertrade is most frequently used to refer to two reciprocal sales transactions in which each party is paid in currency. Despite this technical distinction most observers view barter transactions as a subcategory of countertrade. The two most common types of countertrade are known as counter-purchase and compensation (buy-back) trade.

Counterpurchase

In a counter-purchase arrangement, a private firm agrees to sell products to a sovereign nation and to purchase from the nation goods, which are unrelated to the items, which it is selling. For example, in a series of transactions between a major U.S. manufacturer of commercial aircraft and the government of Yugoslavia, the U.S. firm sold jet aircraft to Yugoslavia and agreed to purchase substantial quantities of Yugoslav crystal glassware, cutting tools, leather coats, and canned hams.

In a counter-purchase transaction, each party is paid in currency upon the delivery of its products to the other party. It is common in such transactions for a private firm to be allowed a period of time following the delivery of the goods that it is selling in which to fulfill its purchase obligation. Periods of from three to

five years, for example, are not uncommon in counter-purchase obligations imposed by the Soviet Union and Eastern European nations. Often, the parties agree upon a list of goods from which the private firm later will be able to select items to purchase.

Private firms resort to a variety of methods to dispose of goods which they are forced to purchase, but most frequently resell these goods to trading companies or directly to end users, often at a discount or “disagio.” Sometimes the private firm will resell the countertraded goods at a price below that which it paid for them, seeking to offset this loss by larger profits generated by the sale of its own product to the nation.

Compensation

The most common form of countertrade is referred to as “compensation” or “buy-back.” In a compensation transaction, a private firm will sell equipment, technology, or even an entire plant to a sovereign nation and agree to purchase a portion of the output produced from the use of the equipment or technology. For example, in the celebrated \$20 billion Occidental Petroleum ammonia countertrade transaction with the Soviet Union, Occidental assisted the Soviets in constructing and financing ammonia plants and agreed to purchase quantities of ammonia produced in these plants over a twenty-year period.

Compensation transactions frequently involve significantly longer periods of time during which the private firm will be permitted to fulfill its purchase obligation than in counter-purchase. In addition, compensation transactions are generally of larger dollar value than counter-purchase transactions. Unlike counter-purchase transactions, the products, which the private firm purchases in compensation, are frequently of marketable quality and in demand in the international marketplace. Further, Western firms frequently are able to negotiate a purchase price for the output that is below the world market price so that the firm can earn a profit in reselling the product, which it is forced to buy.

Barter

Barter, swap, and other types of noncurrency transactions are frequently viewed as forms of countertrade. In many cases, the sovereign nation will impose a barter requirement in a coercive fashion for purposes of disposing of surplus or low quality goods, which it otherwise cannot sell. Barter transactions are frequently utilized in crude oil transfers as a means of conveying crude below official OPEC prices. Similarly, barter is occasionally used as a means of “liberating” blocked currencies or otherwise circumventing foreign exchange controls.

Clearing Agreements

Although countertrade is conducted most frequently between a sovereign nation and a private firm, countertrade arrangements also occur between and among sovereign nations. Nations have historically entered into bilateral or multilateral “clearing agreements” under which they agree to purchase equal values of each other’s products over a specified period of time. This is a form of reciprocal trading not unlike the private firm–sovereign nation relationships discussed above. When an imbalance develops in an account that a nation cannot rectify, private firms known as “switch trading” firms offer to assist the recalcitrant nation in disposing of the goods, which it is required to purchase, usually for a fee.

Framework Agreements

In a countertrade “framework agreement” a private firm establishes a formal, long-term “crediting” mechanism with the host nation under which exports generated by the private firm are routinely credited to the countertrade commitments of numerous third-party firms on an ongoing basis. The key to a framework agreement is that the “crediting” of the offsetting purchases or the escrowing and payment of funds is undertaken on a routine and ongoing basis under a prearranged agreement rather than on the more common case-by-case basis.

“Positive” or “Reverse” Countertrade

In certain instances, private firms prefer countertrade arrangements over conventional transactions. In so-called “positive” or “reverse” countertrade, the private firm views the goods that it will be required to purchase as more valuable than hard currency. This is most often the case when a firm seeks to establish a guaranteed supply of a valuable commodity or production component when it anticipates future shortages of these items. For example, in one of the proposed East–West “gas-for-pipes” transactions, a group of private firms was negotiating with the Soviet Union to transfer equipment and technology for the transportation and production of natural gas to the Soviets in return for guarantees of quantities of natural gas produced through the use of this equipment and technology.

Performance Requirements

A performance requirement is a condition imposed by a sovereign government that requires foreign parties who wish to undertake an investment in that nation to agree to take certain steps to increase exports from the nation. Such steps include the agreement by the foreign investors to export a certain percentage of the output from the investment project, to employ a certain level of local inhabitants in the project, to use a pre-determined level of locally produced components in the manufactured product, and to transfer certain technology to the host nation. Performance requirements are distinguishable from other types of countertrade requirements in that the former involve a private firm’s investment in the imposing nation rather than its sale of goods to the nation. Both practices involve intervention by the host nation in the free market process, however, and in view of their similarity are frequently treated as the same phenomenon.

Collection-through-Export Transactions

A major problem for U.S. firms doing business abroad is the collection of overseas funds, which have been restricted from repatriation due to foreign exchange controls. In such instances, a foreign party as a result of a trade debt might owe funds to a private firm or have profits denominated in local currency, which are earned by a foreign subsidiary. The private firm will have possession of the local currency in the host country, but due to foreign exchange shortages will be unable to convert this currency into dollars. In a collection-through-export transaction, the firm will use the local currency to purchase locally produced goods, export the goods from the host nation, and sell the goods overseas for dollars or another convertible currency.

Figure 1.4 *Doing Business Internationally*: Thomas B. McVey, “Countertrade: Commercial Practices, Legal Issues, and Policy Dilemmas”.

The second currency risk of **repatriation** may present itself when a foreign party attempts to remove hard currency from a host country. Some foreign countries have enacted currency laws that block the movement of hard currencies outside of the country. Less developed countries, for example, have limited hard currency reserves and do not allow them to be used for the purchase of private goods. Once again, countertrade may be the only option available to overcome the repatriation risk of doing business in such countries.

The third and broadest type of currency risk is the devaluation of the currency of payment (**currency rate fluctuations**). The relative value between the dollar and the buyer’s currency may change between the time the deal

Bernina Distributors, Inc. v. Bernina Sewing Mach.*646 F.2d 434 (10th Cir. 1981)*

Distributor of sewing machines brought action against importer of sewing machines for breach of contract. Defendant Bernina Sewing Machine Co. (Importer), a Utah corporation, imports and supplies Bernina sewing machines to plaintiff Bernina Distributors (Distributor). The problems that have arisen relate mostly to pricing and are caused by the fluctuations of exchange rates and decreases in the value of the U.S. dollar versus the Swiss franc. The case involves a long-term supply contract to run for seven years. The contract contained an open price term in which “prices are automatically subject to change when factory costs are increased.” The importer is required to pay in Swiss francs. The open price term allowed Importer to increase price as follows: “(a) To the extent of any increase of factory invoice costs to Importer. (b) To the extent of any increase in duty charges. (c) To the extent of increases in insurance, freight, handling, broker and port fees, or other similar charges. Increases to duty or factory invoice costs shall be adjusted as they occur. Increases to all other charges shall be adjusted at the commencement of each calendar year.” But with the precipitous decline of the dollar in relation to the Swiss franc, Importer’s costs nearly doubled and thus halved its rate of return per dollar invested.

Logan, Circuit Judge. Importer maintains that the risk of currency fluctuations had not been considered or allocated in the contract and that under the Uniform Commercial Code, this “open price term” should be determined according to what the court finds to be reasonable. We believe that the contract provisions are quite comprehensive and hence, the statutory provision is inapplicable to this case. Thus, we believe the contract places the risk of a diminishing profit margin on the Importer and that the Importer bears the risk of currency fluctuations. The Importer also asserts that the court’s interpretation makes the contract impracticable under § 2-615 of the Uniform Commercial Code. The U.C.C. excuses performance under a contract when performance “has been made impracticable by the occurrence of a contingency the nonoccurrence of which was a basic assumption on which the contract was made.” In our view the instant contract is not one made impracticable by the contingency of the devalued dollar. Comment 8 to § 2-615 states that this excuse does “not apply when the contingency in question is sufficiently foreshadowed at the time of contracting.” Also, cost increases

alone do not render a contract impracticable. The loss would have to be especially severe and unreasonable. Importer was aware of the possibility of a reduction in profits due to exchange rate fluctuations and could have guarded against this contingency. For example, a cost-plus formula for determining the price could have been utilized. Furthermore, Importer was represented by counsel throughout and should have known that the contract provided for price increases only to the extent of actual cost increases.

To grant relief on this issue would be to disturb an agreed-upon allocation of risk between commercial equals. The district court did not err in prohibiting Importer from charging Distributor under the contract’s “open price term” a margin of ten percent on increased cost due to exchange rate fluctuations. Furthermore, the contract was not rendered impracticable due to the increase in costs to the Importer related to the currency fluctuation.

Case Highlights

- common practice of entering into long-term supply contracts
- use of open price or price escalation clauses to adjust the contract price over the term of the contract
- a determination that a risk has been allocated to one of the parties defeats a demand for a contract adjustment
- Contract law allows for an excuse from not fulfilling a contract. In the sale of goods the Uniform Commercial Code § 2-615 grants an excuse for commercial impracticability. The law also allows the parties to write an express excuse or *force majeure* clause.
- An excuse for commercial impracticability will not be granted if the risk was foreseeable or where the burden on a party is not unduly severe.
- Since currency fluctuations are foreseeable, courts are likely to view them as allocated risks and are unlikely to grant an excuse.
- It is important to write clear and detailed clauses, especially in long-term contracts. The Court suggested the use of a “cost-plus” formula in the open price term.

is made and the time payment is received. If the exporter is not properly protected, a devaluation of the foreign currency for which payment is to be made could cause the exporter to lose money in the transaction. One of the simplest ways for a U.S. exporter to avoid this type of risk is to quote prices and require payment in U.S. dollars. Then the burden and risk are placed on the buyer to make the currency exchange. If the buyer asks to make payment in a foreign currency, the exporter should consult an international banker before negotiating the sales contract. International banks can help one hedge against such a risk, if necessary, by agreeing to purchase the foreign currency at a fixed price in dollars regardless of the value of the currency when the customer pays. If this mechanism is used, the fees charged by the bank should be included in the price quotation.

The *Bernina Distributors v. Bernina Sewing Machines* case illustrates how a party did not anticipate the risk of a currency rate fluctuation. In this case, a poorly written *open price term* resulted in significant monetary losses due to an unanticipated currency fluctuation.

A foreign importer or exporter can minimize the risk of a negative currency rate change through techniques of **hedging**. This is accomplished by entering into **forward**, **futures**, or **option contracts**. **Arbitrage** is the simultaneous buying and selling of the same foreign exchange in two or more markets in order to take advantage of price differentials. A forward contract requires two parties to exchange specified amounts of two currencies at some future time. The problem with a forward contract is that if the underlying deal falls through, the party is still required to purchase the other currency. The futures contract is like a bond that can be sold prior to maturity. Either party can avoid their obligations under the contract by selling it in the secondary market. A well-developed futures market provides a high level of liquidity, but, just as in the bond market, the value of the futures contract will fluctuate depending on the underlying values of the currencies.

In the *Bernina* case, the importer could have hedged by entering a futures contract to purchase Swiss francs for a fixed amount of dollars. This would have protected it against the subsequent devaluation of the dollar. In fact, the value of the futures contract would have increased in value in the futures market since the contract gives a right to buy Swiss francs at a lower fixed price. Another device used to hedge currency risks is the option contract. A currency option gives a party a right, but not the obligation, to buy or sell a currency at a fixed rate in the future; a purchaser and a seller of foreign currencies agree on a specific rate of exchange at a future date. The purchaser may choose to exercise or pass on the option, thus limiting the effect of unfavorable exchange rate fluctuations. The seller is paid a fee for tendering the option. The right to sell a currency in the future is a *put option*, while the right to buy is a *call option*. The option is obtained by paying a substantial premium whether the option is exercised or not.

Political Risk

Political or country risk broadly refers to the negative consequences that stem from a change in government policies. In the area of import-export, **trade barriers** represent the most common risk. The United States Trade Representative classifies trade barriers into seven general categories:

- import policies including tariffs and other import charges, quantitative restrictions (quotas and embargoes), and import licensing;
- standards, labeling, testing, and certification;
- government procurement restrictions;
- export subsidies;
- lack of intellectual property protection;
- service barriers;
- investment barriers.

A number of international agreements have been adopted that address trade barriers. The Uruguay Round of the GATT addressed all of these trade barriers in some fashion. GATT negotiations traditionally targeted tariff barriers and quantitative restrictions. The original 1947 GATT contained provisions aimed at “reducing fees and formalities

connected with importation and exportation” (Article VIII), “general elimination of quantitative restrictions” (Article XI), and the “publication of trade regulations” (Article X). The **WTO Agreements** that followed the **Uruguay Round** of GATT committed the newly formed WTO to a reduction and elimination of all categories of trade barriers. Nontariff barriers include import quotas and other quantitative restrictions, nonautomatic import licensing, customs charges and fees, customs procedures, export subsidies, unreasonable standards, discriminatory labeling, and discriminatory government procurement policies. The WTO and its role in international trade will be examined in Chapter 5.

The 1994 WTO Agreements included a separate Agreement on Import Licensing. **Technical barriers** to trade are addressed by a number of the WTO Agreements including the Agreement on Technical Barriers, Agreement on the Application of Sanitary and Phytosanitary Measures, Agreement on Customs Valuation, and the Agreement on Preshipment Inspection. Restrictions on foreign government procurement are the subject of the Agreement on Government Procurement. Export subsidies were addressed in the 1947 Agreement in Article VI (Anti-dumping and Countervailing Duties) and Article XXIII (Nullification and Impairment). The 1994 Agreements also included an Anti-dumping Agreement.

Intellectual property protection, barriers to trade in services, and barriers to investment are dealt with directly in separate agreements: the Agreement on Trade-Related Investment Measures (TRIMs), **General Agreement on Trade in Services (GATS)**, and TRIPS. The Investment Agreement prohibits countries from requiring the purchase of domestically produced products, from conditioning the importation of products on a company’s agreement to export products, and from restricting access to foreign exchange. GATS prohibits the use of qualification and licensing requirements as barriers to the establishment of a business or the practicing of a profession by a foreign party. Any such requirements are to be based upon “objective and transparent criteria” and must include “adequate procedures to verify the competence of professionals” from foreign countries. The scope and content of GATS will be reviewed in Chapter 16. The TRIPS Agreement is a comprehensive framework that covers all areas of intellectual property including copyright, trademark, country of origin indicators, patent, industrial designs, and trade secrets. This Agreement will be reviewed in Chapter 18, as well as other international intellectual property rights (IPR) conventions.

A prevalent form of political risk involves changes in government regulation of foreign business activity, sometimes referred to as creeping expropriation. This includes changes in formal regulations, licensing procedures, and the enactment of price controls. Creeping expropriation can also be a less legitimate form of interference such as the extortion of bribes, arbitrary changes in standards and inspection requirements, and the nonenforcement of intellectual property laws. Another major form of political risk is tax calculation and enforcement. A change in the rates, a denial of a tax credit, or a change in accounting rules can be used to manipulate corporate income taxes. Other forms of taxes, such as revenue taxes, can also be manipulated. These taxes are associated with the importation and exportation of goods and include the value-added tax,¹² sales tax, excise tax, and tariffs.

Expropriation and Nationalization

The most extreme form of political risk is expropriation and nationalization. Expropriation is a government seizure of foreign businesses and assets. Nationalization refers to the seizure of all businesses, foreign and domestic, in a particular industry. Both include some form of compensation, but in the past the compensation has not equaled the value of the lost investments. Fortunately, the threats of a foreign government nationalizing an industry or expropriating a foreign company’s assets have severely diminished. The free trade era has made it clear that countries need to attract foreign investment and trade in order to continue to develop. In fact, the opposite of nationalization and expropriation, the privatization of government-owned industries, has been the dominant trend over the past few decades.

In order to encourage foreign investments, many developing countries and former communist countries have passed laws protecting them. In May 1993, for example, Russia enacted Foreign Economic Activity legislation that states that foreign investments on its territory “shall enjoy full and unconditional legal protection.” More

specifically, it states that foreign investments “shall not be subject to nationalization or confiscation except when such measures are adopted in the social interests.” In case of nationalization or confiscation, Russia states it will give prompt, adequate, and effective compensation to the foreign investor.

In the past, the key area of dispute was not whether a country had the legal right to nationalize or expropriate, but the amount of compensation to be paid. Often, the foreign government was willing to pay only the cost paid by the foreign investor. Russia’s foreign investment protection law commits it to pay “the real value of the investments being nationalized.” It further requires the government to pay in hard currency and to pay interest in the event of any delay in the making of the payment.

BITs are another avenue by which countries safeguard foreign investment from expropriation and other investment risks. BITs provide that a host country must not discriminate against foreign investors and must agree to pay prompt, adequate, and effective compensation in case of expropriation. They also provide for alternative dispute resolution by way of arbitration with the **International Centre for Settlement of Investment Disputes (ICSID)**. See Chapter 20 on “Foreign Direct Investment.”

Finally, an investor may obtain insurance to protect its investments in foreign countries. To encourage U.S. companies to invest in developing countries, the U.S. government established the **Overseas Private Investment Corporation (OPIC)**. The OPIC is a government corporation that assists U.S. private investments in developing countries by providing loans, loan guarantees, investment services, and insurance against political risks. The OPIC provides low-cost expropriation insurance to U.S. companies. Eximbank provides financing assistance to U.S. exporters and through the **Foreign Credit Insurance Association (FCIA)** provides different types of insurance coverage. The FCIA works with the Eximbank to provide political and commercial risk insurance to U.S. exporters. Political risk insurance protects against the expropriation of goods, the nonconvertibility of currency, and the inability of a foreign purchaser to obtain an import license.

Risk Management

Before entering a foreign market, a business should measure the degree and likelihood of political risk by performing a formal risk assessment. This may be done internally through research using materials obtained through the U.S. State Department and the OPIC. Some businesses enlist private companies that specialize in risk assessment. If a project is very large, however, then management should meet with government officials of the foreign country to discuss the company’s goals. If possible, a formal **concession agreement** should be negotiated outlining the duties of the foreign government and the rights of the company. It should specify the level of tariffs to be charged, the right of the company to repatriate profits, the host country’s commitment to intellectual property protection, the applicable level of taxation, and the government’s transfer pricing policy.¹³ It is also prudent to require the use of mediation and arbitration in case of a dispute. Table 1.5 provides a list of U.S. government agencies and programs that assist American companies wanting to do business internationally.

Managing Risk Through Insurance and Government Assistance Programs

As noted above, OPIC is a federal agency that facilitates U.S. foreign direct investment in developing nations and emerging market economies. OPIC is an independent, financially self-supporting corporation that is fully owned by the U.S. government.

OPIC encourages U.S. investment projects overseas by offering political risk insurance, all-risk guarantees, and direct loans. OPIC political risk insurance protects U.S. investment ventures abroad against the uncertainties of civil strife and other violence, expropriation, and inconvertibility of currency. In addition, OPIC can cover business income loss caused by political violence or expropriation. OPIC can offer up to \$400 million in total project support for any one project—up to \$250 million in project financing and up to \$250 million in political risk insurance. The amount of insurance and financing available to projects in the oil and gas sector with offshore, hard-currency revenues is \$300 million per product and \$400 million if the project receives a credit evaluation of investment grade

Table 1.5 U.S. Agencies and Assistance Programs

<i>U.S. Government Agencies and Export Assistance Programs</i>	<i>Description</i>
U.S. Department of Commerce (DOC)	Branch of government responsible for promoting domestic economic growth
U.S. Commercial Service (CS)	Trade promotion arm of the U.S. Department of Commerce's International Trade Administration
International Trade Administration (ITA)	Department of Commerce bureau responsible for export promotion programs
Small Business Administration (SBA)	Government agency that manages programs for U.S. exporters, including finance programs
Trade and Development Agency (USTDA)	Government agency that provides grants for feasibility studies in developing countries
Department of Agriculture (USDA)	Branch of government responsible for developing and executing federal government policy on farming, agriculture, forestry, and food
Agency for International Development (USAID)	Government agency that procures goods and services from U.S. companies for use in developing countries
Trade Fair Certification Program (TFC)	Certifies international trade events so U.S. companies can know ahead of time if an event is high quality and offers opportunities
Multilateral Development Bank (MDB)	Institution created by a group of countries to provide development-related financing and professional advising
Small Business Development Center (SBDC)	National network of counselors for small enterprises (offers services that can help first-time exporters)
International Buyer Program (IBP)	Department of Commerce program that matches U.S. exhibitors at select U.S. trade shows with foreign buyers
Central Intelligence Agency (CIA)	Gathers intelligence and statistics (publishes the <i>World Factbook</i> , an important market research resource)

or higher from major ratings agencies. However, the maximum support OPIC may offer an individual project is \$400 million, either by combined or single OPIC products.

Once the potential risk is assessed, a business can insure against a loss by obtaining political risk insurance. OPIC offers four types of insurance coverage. First, it insures against restrictions on the repatriation of profits. Second, it insures against expropriation and nationalization. Third, it insures against damage to assets due to war or civil strife. Fourth, it provides business interruption insurance for losses of income resulting from political disturbances. The OPIC will also insure banks willing to finance export transactions, enabling a bank to confirm a letter of credit from a risky importer and its bank. OPIC insurance is available only to American investors or exporters undertaking business in a foreign country with which the United States has entered into a BIT. In addition, OPIC is allowed to sue a foreign country because BITs require the foreign country to waive sovereign immunity protection.

An internationally based investment insurance company is the **Multilateral Investment Guarantee Agency (MIGA)**. Established in 1988 as part of the World Bank, MIGA encourages investment in developing countries through the mitigation of noncommercial investment barriers. It provides insurance against expropriation, war, and other noncommercial risks and offers investment guarantees for foreign direct investments, as well as licensing, franchising, and transfers of technology.

The determination of whether political or commercial risk insurance will be needed should be made when negotiating the underlying contract, and the cost and type of insurance to be procured should be stated in the contract. Insurance procurement may be subject to foreign government regulation. In China, for example, insurance in conjunction with a joint venture must be obtained through a Chinese insurance company. The decision to obtain commercial insurance may be dictated by the commercial lender. Provisions in the underlying contract should also be reviewed for their potential impact on subsequent insurance claims. For example, choice of law clauses should be reviewed to determine if there are laws that preclude the insured from making a claim under its insurance policy.

The application for insurance, like the application for a letter of credit, is contractual in nature. The applicant should read the form carefully and answer it as honestly and comprehensively as possible. The general rule is that

the applicant must disclose any information that would “materially” influence the insurance company’s decision to grant the requested insurance.¹⁴ In the related area of marine insurance, a court stated that: “an applicant for a marine insurance policy is bound to reveal every fact within his knowledge that is material to the risk.”¹⁵ In that case, an owner of a company failed to disclose that he had previously filed claims for more than two-dozen losses at sea. The court found that there was sufficient evidence for fraud in intentionally concealing material facts and allowed rescission (voiding) of the insurance policy.

Typical provisions found in most insurance contracts include a description of the insured property, a definition of an act of expropriation, waiting period, notice, warranties, recoveries, duty to minimize loss, and definition and computation of loss. An investor should closely scrutinize the definition of expropriation found in its insurance policy. Does the policy cover both partial and total loss due to expropriation? A “waiting period” is often required between the loss and collecting on the insurance policy. In large projects the waiting period can be as long as a year. The duties of the insured regarding the preservation of the investment and any claims pertaining to the loss should be clearly defined. A warranty provision often requires the insured to take steps in order to preserve its coverage. For example, the insured may have to certify that it will comply with relevant host country laws and that the uninsured portion of the investment will remain uninsured. Also, rights to recoveries made after payment on the claim should be defined.

Other government export assistance programs and assistance include the **U.S. Trade and Development Agency (USTDA)**, which works directly with individual companies and manufacturing and service associations to identify trade opportunities and obstacles by product or service, industry sector, and market. USTDA’s industry and international experts conduct executive trade missions, trade fairs, marketing seminars, and business counseling, and provide product literature centers. Another important government entity is the Eximbank, which provides export credit insurance, loan guarantees to lenders, direct loans to exporters on market-related credit terms, and loans to foreign buyers. Eximbank working capital guarantees enable lenders to provide the financing that an exporter needs to purchase or produce a product for export, as well as to finance short-term accounts receivable. Eximbank offers export credit insurance to offset the commercial and political risks that are sometimes associated with international trade.

The **U.S. Commercial Service (CS)** provides numerous practical services including locating and evaluating overseas buyers and representatives, distributors, resellers, and partners; international trade opportunities; foreign markets for U.S. products and services; export financing; export documentation requirements; U.S. export licensing requirements and import requirements of foreign nations; export seminars and conferences; and e-commerce strategies. Attached to CS is Commercial Service Overseas. U.S. CS officers work in more than 150 offices located in more than 75 countries. They provide a range of services to help companies sell in foreign markets, including background information on foreign companies; agent-distributor locator services; market research; due diligence on distributors and direct buyers; business communication in a cultural context; counseling on entry strategies, pricing, and promotion; and arrange appointments with key buyers and government officials.

Managing Risk Through Intermediaries

Using professional consultants and agents can reduce exporting, licensing, and foreign direct investment risks. International specialists such as freight forwarders, customs brokers, political risk analysts, international lawyers, and commercial insurance companies all offer expertise and services.

Customs brokers assist importers with the entry of goods into foreign countries, their classification and valuation, and the payment of duties. In the United States, customhouses are licensed under Part III of Title 19 of the Code of Federal Regulations in order to transact business with the Customs Service. They can be hired to provide the necessary import and customs documents.

Customs brokers provide a variety of vital services including advising the importer on the formalities, regulations, and tariff (taxes or duties) fees for the specific country of import. It should be noted that under some trade terms, such as DDP (see Chapter 14), the “importer” might actually be the exporter. Under the DDP term, the seller has the obligation to clear the goods through customs and pay tariff fees at the country of import. The customs broker advises

the importer on selecting a HTS classification number (see Chapter 6) in the hope of paying a lower tariff rate. It also prepares and reviews the customs documents, delivers them to the customs authorities, and obtains the document releasing the goods for importation. Additional services provided by customs brokers include arranging for the warehousing of the goods at the port of importation (after the goods clear customs). The documents issued by the customs broker include the Application for Import License, Import Declaration, and Special Customs Invoice.

Generally, the seller or exporter hires the freight forwarder, while the customs broker is the agent for an importer or purchaser. Export freight forwarders must be certified by the Federal Maritime Commission to handle ocean freight. The **freight forwarder** often arranges all documentation needed to move a shipment from origin to destination and assembles documents for presentation to the bank in the exporter's name. The forwarder arranges for cargo insurance, notifies the buyer of the shipment, and advises the shipper of marking and labeling requirements. In exchange, the forwarder is paid a fee by the exporter and may receive a percentage of the freight charge from the common carrier. The international banker offers financing assistance, provides guarantees of payment, and facilitates the movement of documents between the parties.

The **International Trade Administration (ITA)** is an agency within the U.S. Department of Commerce whose mission is to foster economic growth and prosperity through global trade. ITA provides practical information to help you select your markets and products, ensures that you have access to international markets as required by our trade agreements, and safeguards you from unfair competition such as dumped and subsidized imports. ITA is made up of the following four units: (a) Manufacturing and Services, the industry analysis unit that supports U.S. industry's domestic and global competitiveness; (b) Commercial Service, the trade promotion unit that helps U.S. businesses at every stage of the exporting process; (c) Market Access and Compliance, the country-specific policy unit that keeps world markets open to U.S. products and helps U.S. businesses benefit from our trade agreements with other countries; and (d) Import Administration, the trade law enforcement unit that ensures that U.S. businesses face a level playing field in the domestic marketplace.

Another important third-party service is the **ATA Carnet**. The ATA Carnet is a standardized international customs document used to obtain duty-free temporary admission of certain goods. The abbreviation ATA is derived from the French words *admission temporaire* and the English words *temporary admission*. Countries that are signatories to the ATA Convention require the Carnet. Under the ATA Convention, commercial and professional travelers may temporarily take commercial samples; tools of the trade; advertising material; and cinematographic, audiovisual, medical, scientific, or other professional equipment into member countries without paying customs duties and taxes or posting a bond at the border of each country to be visited. You should contact the U.S. Council for International Business to determine whether the country you are visiting is a member of the ATA Convention. Carnets are generally valid for 12 months.

Countertrade

Countertrade is used to overcome currency convertibility and repatriation problems or the capital shortcomings of a foreign party.¹⁶ This section will discuss some of the common forms of countertrade including barter, **buy-back**, and **counter-purchase**. A **barter transaction** involves an exchange of goods or services, but barter agreements are not always simple, cashless, single document arrangements. They sometimes involve two separate documentary sales, often with separate letters of credit. A form of countertrade known as counter-purchase is an economic transaction in which one party sells goods to the second party and, in return, the first party agrees to purchase goods from the second party so as to achieve an agreed balance of trade ratio. A variant is the **offset agreement**. "Offsets constitute an agreement by the foreign seller to include as part of the sale in the foreign nation the use of parts or services from local suppliers." An offset satisfies local content requirements where the host country mandates that a certain percentage of a good be a product of local materials and labor. In buy-back or compensation transactions, exporters of heavy equipment, technology, or entire manufacturing facilities agree to purchase a certain percentage of the output of the facility. See Figure 1.4's explanations of the different types of countertrade.

The Department of Commerce can advise and assist U.S. exporters faced with countertrade requirements. The Finance and Countertrade Division of the Office of Finance, Industry, and Trade Information monitors

countertrade trends, disseminates information, and provides general assistance to enterprises seeking barter and countertrade opportunities. Another source for information and contract clauses dealing with countertrade is the **United Nations Commission on International Trade Law (UNCITRAL)**. It publishes a *Legal Guide on International Countertrade Transactions* that provides information on how best to structure a countertrade transaction. It also discusses the types of clauses generally found in countertrade contracts. The clauses discussed in the *Guide* include: type, quality, and quantity of goods; pricing of goods; participation of third parties; payment; restrictions on resale; liquidated damages; security for performance; failure to perform; choice of law; and settlement of disputes.

Because of the difficulty in finding marketable goods in a foreign country to fulfill a countertrade commitment, certain clauses take on added importance. First, an extended period of time should be allotted to the exporter to obtain host country goods to satisfy its countertrade obligations. Second, a broad list of countertrade goods should be negotiated to enhance the exporter's chances of finding marketable goods. Third, because of the poor quality of some foreign goods, the exporter should negotiate broad inspection rights. Also, the costs and uncertainty of the countertrade arrangement may warrant the granting of a *disagio* (discount) of the amount of goods to be purchased to fulfill the countertrade commitment.

Another provision included in countertrade contracts is a penalty clause for nonperformance of the countertrade commitment. In some cases, paying a penalty instead of purchasing unmarketable goods may make better economic sense for the exporter. Of course, the penalty clause should make clear that payment of the penalty releases the exporter from any further liability.

It is important to note that the counter-purchase arrangement is more of a currency transaction than a sale of goods. The foreign government is concerned that it maintains its level of foreign (hard) currency reserves. When releasing (selling) hard currency to one of its nationals to facilitate the purchase of importing goods, the government wants to be assured that an equal amount of hard currency is subsequently returned to the country. Therefore, an exporter of goods may satisfy its counter-purchase obligations not only by purchasing goods from the foreign country, but also through a currency transaction. For example, an American company undertakes a counter-purchase transaction with an importer from Mexico and gets paid in U.S. dollars. The American company has no interest in purchasing Mexican goods and does not want to pay another company to make such a purchase. Instead, it may make a deal to purchase soft currency from Mexico. For example, if a Mexican company purchases goods from Chile and gets paid in Chilean pesos, the American who happens to buy goods from Chile could agree to buy the Chilean pesos from Mexico with U.S. dollars. This arrangement satisfies the American company's counter-purchase obligation—U.S. dollars flow back into Mexico, and the American company can immediately buy Chilean goods with the acquired pesos.¹⁷

Developing an Export Plan

Before attempting to export, a firm should develop an export plan that answers the following ten questions: (1) What countries are targeted for sales development? (2) What products are selected for export? What modifications, if any, must be made to adapt them for overseas markets? (3) In each country, what is the basic customer profile? What marketing and distribution channels should be used to reach customers? (4) What special challenges pertain to each market (competition, cultural differences, import controls, etc.), and what strategy will be used to address them? (5) How will the product's export sales price be determined? (6) What specific operational steps must be taken and when? (7) What will be the time frame for implementing each element of the plan? (8) What personnel and company resources will be dedicated to exporting? (9) What will be the cost in time and money for each element? (10) How will results be evaluated and used to modify the plan? Any reasonable export plan should be fact-based and be the product of an extensive analysis of the targeted foreign market. It should provide short-term and long-term objectives and milestones to be reached based on those objectives. The next *Focus on Transactions* feature provides an outline of a generic export plan.

The way a company chooses to export its products can have a significant effect on its export plan. One goal of the export plan will be to determine whether the firm should export directly or indirectly. The basic distinction between

<p>Is your company's management committed to pursuing export operations? The following areas of concerns should be covered in the export plan:</p>	
<p>Part I. Situation/Background Analysis</p> <ul style="list-style-type: none"> background data on target countries and market basic market statistics: historical and projected benefits from existing Free Trade Agreements export compliance classification of products under the Harmonized Tariff Schedule personnel and export organization resources of the firm evaluation of industry structure, competition, and demand. 	<ul style="list-style-type: none"> terms and conditions: selection of proper trade term(s) (<i>Incoterms</i>) to determine additional costs to be internalized in product pricing sales goals: profit and loss forecasts.
<p>Part II. Marketing Component</p> <ul style="list-style-type: none"> identifying, evaluating, and selecting target markets product selection and pricing: product pricing including costs associated to seller, such as freight, insurance, and import costs; additional costs, such as foreign advertising and web site development distribution methods 	<p>Part III. Tactics: Action Steps</p> <ul style="list-style-type: none"> determining primary target countries and secondary target countries (Test primary market first and then target secondary markets.) Consider use of indirect exporting at first to test market before moving to direct exporting based upon marketability of product. selection and use of a foreign distributor Devise and implement strategy for protecting intellectual property and confidential information (before exporting goods or hiring a foreign distributor).
	<p>Part IV. Export Budget</p> <ul style="list-style-type: none"> pro forma financial statements
	<p>Part V. Implementation Schedule</p> <ul style="list-style-type: none"> follow-up: periodic operational and management review (measuring results against plan)

Figure 1.5 Focus on Transactions: Sample Outline for an Export Plan.

Source: U.S. Commercial Service, A Basic Guide to Exporting (2015).

these approaches to exporting relates to a company's level of involvement in the export process. Firms that are new to exporting or are unable to commit staff and funds to more complex export activities may find indirect exporting appropriate. Exporting indirectly through intermediaries leaves it to the intermediary firm to find foreign markets and buyers for its products. EMCs, ETCs, international trade consultants, and other intermediaries can give the exporter access to well-established expertise and trade contacts. A firm contemplating a greater involvement in a foreign market will need to seek the expertise of a foreign lawyer.

The direct exporting approach is the more ambitious and difficult, since the exporter personally handles every aspect of the exporting process from market research and planning to foreign distribution and collections. Consequently, a significant commitment of management time and attention is required to achieve good results. However, this approach may also be the best way to achieve maximum profits and long-term growth. With appropriate help and guidance from third-party experts including freight forwarders and international banks, even small or medium-sized firms can export directly if they are able to commit enough staff time to the effort. For those who cannot make that commitment, the services of an EMC, ETC, trade consultant, or other qualified intermediary is indispensable.

A company may take a multifaceted approach to exporting. For example, it may elect to export directly to nearby markets such as Canada or Mexico, while letting an EMC handle more ambitious sales to Saudi Arabia or China. An exporter may also choose to gradually increase its level of direct exporting, after it has gained experience and sales volume appears to justify added investment.

Chapter Summary

- 1 The intent of Chapter 1 is to provide the framework for the coverage of the book's remaining 20 chapters by highlighting the reasons for doing business internationally, the methods of doing business internationally, the risks of doing business internationally, and the means of mitigating those risks. Finally, Chapter 1 exposes the student to much of the terminology used in international trade and throughout the rest of this book, as can be seen on the list below of "Key Terms."

- 2 There are three generic methods of doing business internationally: (a) exporting–importing of goods and services, (b) licensing of technology and intellectual property rights, and (c) foreign direct investment.
- 3 In the sale of goods there are a number of direct ways of selling in foreign markets. The generic division is between direct exporting and indirect exporting. There are a number of methods of direct importing: (a) direct sales to foreign customers, (b) sales to foreign distributors, and (c) consignment sales. Indirect exporting is often done through a third-party export management consultant (EMC), an exporting trading company (ETC), or a remarketer.
- 4 The risks associated with international business include: (a) pricing risks, (b) legal risks, (c) cultural and language risks, (d) currency risks, and (e) political risks.
- 5 There are three types of currency risks: (a) convertibility, (b) fluctuation, and (c) repatriation. Hedging is a common way of mitigating currency risks and includes the use of currency options, futures contracts, and forward contracts.
- 6 Another form of minimizing currency risks and the risks of entering a venture with an undercapitalized foreign entity is countertrade. The common forms of countertrade include: (a) barter, (b) counter-purchase, and (c) buy-back or compensation.
- 7 There are numerous government or quasi government assistance, insurance, and finance programs that can be used in doing business internationally. A few of the important ones include: (a) Overseas Private Investment Corporation (OPIC), (b) Multilateral Investment Guarantee Agency (MIGA), (c) U.S. Trade and Development Agency (USTDA), (d) Eximbank, (e) U.S. Commercial Service, and (f) International Trade Administration (ITA).
- 8 There are a number of third parties that provide necessary services for the exporting–importing of goods, including: (a) commercial banks, (b) insurance companies, (c) common carriers, (d) customs brokers, (e) freight forwarders, and (f) ATA Carnet.

Key Terms

Arbitrage	Export Management Company (EMC)	Indirect Exporting
Article 38 of the Statute of the International Court of Justice	Export Trading Company (ETC)	International Centre for Settlement of Investment Disputes (ICSID)
ATA Carnet	Exporting–Importing	International Chamber of Commerce (ICC)
Barter Transaction	Expropriation	International Court of Justice
Basket of Risks	Foreign Credit Insurance Association (FCIA)	International Trade Administration (ITA)
Bilateral Investment Treaty (BIT)	Foreign Direct Investment (FDI)	Joint Venture
Buy-Back	Foreign Distributor	Jurisdiction, Personal
Buying Agent	Foreign Sales Representative	Jurisdiction, Subject Matter
Commission Agent	Forward Contract	<i>Lex Mercatoria</i>
Concession Agreement	Franchise; Franchising	Licensing
Consignment	Free Trade Agreement (FTA)	Multilateral Investment Guarantee Agency (MIGA)
Convertibility	Freight Forwarder	Nationalization
CIF (Cost, Insurance, and Freight)	Futures Contract	Ninth Ministerial Conference (WTO)
Counter-Purchase	General Agreement on Tariffs and Trade (GATT)	Nontariff Barriers
Countertrade	General Agreement on Trade in Services (GATS)	North American Free Trade Agreement (NAFTA)
Currency Option	Global Supply Chain	Offset Agreement
Currency Rate Fluctuation	Hedging	Option Contract
Customary International Law	Home Country	Overseas Private Investment Corporation (OPIC)
Customs Broker	Host Country	
<i>Disagio</i>		
Evergreen Laws		
Eximbank		

Privatization	Trade in Goods	Uruguay Round
Remarketer	Transfer Pricing	U.S. Commercial Service
Repatriation	United Nations Commission on	(CS)
Sale of Services	International Trade Law	U.S. Trade and Development
Technical Barriers	(UNCITRAL)	Agency (USTDA)
Trade Barriers	United Nations Convention on	World Trade Organization
Trade Facilitation Agreement	Contracts for The International	(WTO)
(TFA)	Sale of Goods (CISG)	WTO Agreements

Chapter Problems

- 1 Use Tables 1.1 and 1.2 to calculate the U.S. balance of trade (Exports of Goods) – (Import of Goods) vis-à-vis our major trading partners. What is the importance of such a calculation? Is a negative balance a reason for alarm?
- 2 You are a manager at a U.S. company that manufactures moderately priced personal computers. The company is contemplating expanding overseas with an initial emphasis on exporting to Latin America. You have been assigned the task of preparing a preliminary market analysis for the country of Brazil. Using the sources found in the *Focus on Transactions* feature on page 11, conduct market research. Prepare a report that focuses on the opportunities and pitfalls of exporting to Brazil and offer recommendations.
- 3 As Vice President for Foreign Operations of a U.S. multinational corporation you have been asked to prepare a report for the Board of Directors regarding “doing business” in Germany and Nigeria. Please discuss the following in your report: (1) the different ways of “doing business” in foreign countries, (2) the way you would recommend for each of the two countries mentioned, (3) the risks of doing business in these countries, and (4) ways of minimizing those risks.
- 4 A U.S. businessperson enters into a joint venture with an Italian company in the business of manufacturing and selling agricultural and vegetable products. The joint venture agreement gives the U.S. businessperson a 50 percent equity ownership in the joint venture. The parties also enter into a shareholder agreement that restricts the shareholders’ ability to transfer shares without offering the other shareholders the opportunity to purchase the shares and that provides for arbitration of any shareholder disputes in Rome, Italy. The Italian defendant attempts to purchase ownership interest in the joint venture of the Italian company. The U.S. businessperson sues in the United States on the ground of tortious interference with the shareholder agreement. The plaintiff asserts that a tort claim is outside the scope of the arbitration clause since it is restricted to contract claims directly related to the shareholder agreement. Is the plaintiff correct on the issue of arbitration or will the plaintiff be forced to arbitrate in Rome, Italy? *Marchetto v. DeKalb Genetics Corp.*, 711 F. Supp. 936 (N.D. Ill. 1989).
- 5 Your company is contemplating exporting goods to the following countries: France, Hungary, and Nigeria. Research the following: (1) the currency of each country and the current conversion rate into U.S. dollars and (2) restrictions in each country pertaining to the conversion of the national currency into U.S. dollars and any repatriation limitations. Check the U.S. Department of State Country Commercial Guides for each of these countries for relevant information. If the currency risks are severe for any of these countries, what alternatives should you explore in order to do business in these countries?

Internet Exercises

- 1 Review the web site of the International Court of Justice for information on current court cases: <http://www.icj-cij.org>.
- 2 Review the online catalog of materials published by International Chamber of Commerce Publishing, SA, at <http://www.iccbooks.com>.

- 3 Review the web site of the World Intellectual Property Organization at <http://www.wipo.org> for materials that would be of assistance to someone contemplating the international licensing of intellectual property rights.
 - 4 The more than 50 Trade Policy and Programs (TPP) professionals and staff, in partnership with agencies across the federal government, work to maximize the benefits of open markets for global economic development, address and resolve trade disputes, and improve access for U.S. goods and services abroad. Review the TPP site (<http://www.state.gov/e/eb/tpp>) to find the current issues being pursued by the TPP.
 - 5 Search the web for sites of international law firms that provide assistance to companies undertaking international business transactions. Some of these sites provide interesting articles and links to current developments in the law of international business transactions.
 - 6 Your company manufactures a popular brand of clothing with a world-recognized trademark. You are asked to prepare a political risk report on exporting to two countries in Europe of your choosing. One country is to be a member of the European Union and the other is in Eastern Europe.
- 7 Compare the different types of risk for the two countries. Recommend a market entry strategy (exporting, licensing, direct investment) for each country. A good place to start is the U.S. Department of State Country Commercial Guides for each country at <http://www.state.gov>. Using the template “A Step-by-Step Approach to Market Research” provided earlier in the chapter, write a market research report for a small American electronics company that produces portable radios and MP3 players, using the following readily available resources:
 - U.S. Commercial Services at export.gov
 - Small Business Administration at sba.gov
 - USA Trade® Online at usatrade.census.gov
 - Trade Stats Express at tse.export.gov
 - United Nations Statistical Yearbook at unstats.un.org/unsd/syb
 - World Bank Atlas of Global Development at data.worldbank.org/products/atlas
 - World Development Indicators at data.worldbank.org/products/wdi
 - CIA World Fact Book at 1.usa.gov/1tUj7vg
 - International Monetary Fund (IMF) Data and Statistics at imf.org/external/data.htm

Other Internet Sources

World Bank: <http://www.worldbank.org> (provides statistics and information on international trade and finance).

Links to Lex Mercatoria Developments: <http://www.jus.uio.no/lm>. This web site describes itself as a monitor for developments in customary international law and Internet infrastructure.

International Trade Administration: <http://www.trade.gov> (provides export assistance and information on doing business with foreign countries).

Department of State: <http://www.state.gov>. The U.S. State Department publishes commercial guides and country profiles for numerous foreign countries. This is a good place to start to learn about differences in culture and business customs. Go to the above homepage and click a country under the “Country Profiles” box.

American Society of International Law: <http://www.asil.org> (provides information on current developments in international law, along with links to international documents and analysis).

World Trade Organization: <http://www.wto.org> (provides links to all WTO Agreements).

Overseas Private Investment Corporation: <http://www.opic.gov> (review its products including political risk insurance).

Notes

1 ICC, *Rethinking Trade and Finance 2014* at 23.

2 See generally, Ward Bower, “The Future Structure of the Global Legal Marketplace,” *The Metropolitan Corporate Counsel* (1999).

- 3 The International Court of Justice (ICJ) or World Court is located at The Hague in the Netherlands. Its Statute, a part of the United Nations Charter, dictates the jurisdiction and powers of the court.
- 4 Arthur Rosett, "Critical Reflections on the CISG," 45 *Ohio State Law Journal* 265, 287 (1984).
- 5 See generally, Roy Goode, "Usage and Its Reception in Transnational Commercial Law," 46 *International & Comparative Law Quarterly* 1 (1997); Lord Mustill, "The New Lex Mercatoria: The First Twenty-Five Years," 4 *Arbitration International* 86 (1988).
- 6 The Hague Rules were codified in the United States as the 1936 Carriage of Goods by Sea Act (COGSA), which applies to an international export or import shipment involving a bill of lading for transport from or to a United States port.
- 7 The UCP was first published in 1933 and subsequently revised in 1951, 1962, 1974, 1983, and 1993. The UCP 600 came into effect on July 1, 2007.
- 8 United Nations Convention on Contracts for the International Sale of Goods (April 11, 1980), U.N. Doc. A/CONF.97/18, Annex I, reprinted in 19 I.L.M. 668.
- 9 Hugh Beale and Tony Dugdale, "Contracts Between Businessmen: Planning and the Use of Contractual Remedies," 2 *British Journal of Law & Society* 45, 49 (1975).
- 10 *Nachfrist* notice is the requirement that a party grant an extension of time to perform the contract upon the request of the other party. *Nachfrist* notice will be examined in Chapter 12.
- 11 Discovery is the pretrial process whereby the litigants uncover evidence by questioning the other party either in writing (interrogatories) or in person (depositions) and by examining documents provided by the other party to the litigation.
- 12 Value-added tax (VAT) is a popular method of taxation in Europe. It imposes a tax on goods and services at each stage of the production process equal to the value added to the product at each stage. It is similar, but not identical, to a sales tax.
- 13 **Transfer pricing** is the price that an affiliated company, such as a subsidiary, charges another affiliated company. Manipulation of transfer prices can be used to move profits and costs from a high-tax to a low-tax country.
- 14 See New York Insurance Law §3105 (McKinney's).
- 15 Cigna Property & Casualty Insurance Co. v. Polaris Pictures Co., 1998 WL 734391 (9th Cir. 1998).
- 16 See generally, John Grabow, "Negotiating and Drafting Contracts in International Barter and Countertrade Transactions," 9 *North Carolina Journal of International Law & Commercial Regulation* 255 (1984).
- 17 Source: International Trade Administration, *Trade Finance Guide* (November 2012).

ETHICS OF INTERNATIONAL BUSINESS

This textbook's primary focus is on the *legal* implications of doing business internationally. This chapter will emphasize some of the important *ethical* implications of international business dealings and will explore how a multinational business confronts the issues of transnational ethics. The importance of ethics pervades all areas of business, government, and society. This chapter will focus on a few areas most related to doing business internationally: (1) host–home country standards, (2) bribery and corruption, and (3) sustainability and environmental ethics. At the end of the chapter, a case study—“Choosing Values: Public–Private Relationships in a Global Economy”—is provided that involves real world decision-making which relates to all three of these ethical areas.

Most international business decisions have both legal and ethical implications—how to address differences between host country and home country standards, for example. Generally the legal answer to this dilemma is quite clear—since the business activity transpires within the jurisdiction of the host country, then the businessperson need only comply with the standards of the host country, assuming no extraterritorial application of home country law. The ethical answer is much more complicated. If the host country's standards are lower than those of the home country, are complying with the lesser standards ethical? Most U.S. companies face this question when starting business operations in lesser-developed countries. Answering this question becomes more difficult if the lesser standards are likely to result in harm to people or the environment. Ultimately a multinational company may be *ethically* required to apply standards higher than those of the host country.

Demarcating the line between law and ethics and accounting for ethical factors in business decisions is crucial to international business transactions. The ethical assessment is complicated by differing cultural and national outlooks on what is ethically appropriate and will be influenced by the nuances of culture, religion, and economics. **Ethical or cultural relativism**, which holds that because different countries or cultures have different ethical belief systems there is no supranational way of determining whether an action is right or wrong, is often used to argue that ethical decisions are confined within the boundaries of a given country or culture. Ethical relativism asserts that the correctness of an action is to be measured by whatever a majority within a society believes is morally correct. The alternative belief system to ethical relativism is *absolutism*, which holds that certain moral and ethical principles should be upheld in all cultures and countries. Human rights documents are given as examples of core principles that should be followed by all civilized countries.

The problem of cultural relativism that confronts all multinational enterprises will be examined in the context of four common areas of concern: environment, standards, bribery, and advertising. Before exploring these issues in detail, an exploration of general ethical schools and approaches will provide insight.

Business Ethics

Despite the debate between those who argue for absolutism and those who argue for ethical relativism, decision-makers need ethical tools that can guide them in making ethically correct decisions. Business managers often do not recognize the ethical implications of their decisions. From the perspective of corporate profits and credibility, a good reputation in the global marketplace has become paramount for most multinational enterprises, partly because bad ethical practices are readily apparent in an increasingly transparent global economy. Multinational companies

are often the target of surveillance by the media, government agencies, competitors, private watch groups, and even their own employees. Public relations disasters resulting from unethical practices can be catastrophic.

To better sensitize employees to ethical issues, there must be some agreement on what is right or wrong. Some basic assumptions regarding the rightness of certain practices and activities must be made. These basic assumptions are descriptive, not normative, in nature. For example, the issue will not be whether bribery is wrong, but whether Americans or citizens of most civilized nations believe that bribery is wrong. A review of the traditional schools of ethics provides a starting point for the U.S. businessperson's approach to ethical decision-making, and will enable the businessperson to better apply moral reasoning to ethical problems in the international setting. The ethical schools to be reviewed include utilitarianism, rights and duties, virtue, and ethics of care.

Utilitarianism

The **utilitarian** approach is a teleological approach to ethics. Teleology or consequentialism looks to the consequences of a decision or an action to determine if it was ethically appropriate. There are many different formulations of this approach. The most basic or crude form of utilitarianism is **hedonism** or **egoism**, which simply determines the rightness of an action on whether it produces more good than bad effects for the individual decision-maker. In the area of business, egoism is often associated with the economics of Adam Smith, an eighteenth-century Scottish philosopher generally regarded as the father of modern economics. His masterwork, *The Wealth of Nations*, was published in 1776. In it Smith provided the rationalization for free market economics: Individuals should be allowed to make decisions based upon their own narrow self-interests. If not interfered with, such rational self-interest will produce an efficient economy that benefits society as a whole. Smith's view of self-interest and the free market has largely been misunderstood, however. Smith's moral philosophy as described in his other masterwork, *A Theory of Moral Sentiments*, saw *rational* self-interest as incorporating many altruistic factors not normally associated with the economic man of free market theory.

Another, simplified version of utilitarianism is the economic concept of benefit-cost. **Benefit-cost analysis** attempts to monetize the ethical determination by placing a dollar value on the benefits and costs of an action from the narrow perspective of the decision-maker. The danger of this narrow interpretation of utilitarianism was demonstrated in the infamous Pinto automobile case. The decision not to install a relatively inexpensive device to prevent rear-end explosions was based upon a narrow dollar calculation, which concluded the cost to defend and settle personal injury and wrongful death lawsuits was less than the costs of incorporating the safety feature. This analysis raises the questions: Is an examination of benefits and cost performed solely from the perspective of the automobile company ethically sufficient? How does one place a value on human life or well-being? Are certain concerns, such as human life, **dominant considerations** that outweigh the other factors in the benefit-cost equation?

A true utilitarian analysis attempts to weigh all direct and indirect effects from the perspectives of all parties or stakeholders affected and not just from the perspective of the decision-maker. It is imperative for the decision-maker to continuously expand the utilitarian analysis to take into account as many effects and stakeholders as possible. It is also important to seek out alternatives that would minimize costs (harm) and increase the net benefit. Benefit-cost utilitarianism fails to take into account how the net benefit of an action is distributed. Thus, a multinational company decision that creates a net benefit is unlikely to be ethical if the company retains the entire net benefit and the host country and its people receive none. In other cases, some developing countries a few leaders and their associates might hoard the host country's benefits.

Dominant considerations relate to **incommensurability**. How does one value life, equality, health, and so on? One can argue that we make those valuations every day in determining what is a reasonable level of safety or what is a reasonable level of pollution. A utilitarian would argue that the market establishes society's preference level of safety or pollution. Did the market establish reasonable levels in the Pinto decision, where safety concerns were ignored? Did the individual consumers? Would the actions of the manufacturer have been more ethical if they had disclosed the dangers of rear-end explosions? Would they have been absolved of moral responsibility if they had offered the consumer the option of purchasing the safety device?

Critics argue that the utilitarian calculation should be the first stage in a two-stage process. A second stage would analyze how the net benefits are distributed. This process is associated with the notion of **distributive justice**. The second stage may also weigh the effects of an action from the perspective of individual rights and entitlements. For example, if a net benefit results in the diminishment of basic human rights, then the action would be considered unethical. In essence, certain concerns, such as human rights, would take priority over the results of a purely utilitarian analysis. This idea that certain things are sacrosanct is part of the concept of dominant considerations. Certain negative consequences can preempt the determination that an action creates the “greatest good for the greatest number.”

If an action produces the greatest good at the expense of the rights of a minority, then utilitarianism fails in its sanctioning of such an action as ethical. In sum, an international businessperson using a utilitarian approach to decision-making should list all those affected by the decision. The businessperson then must value the good and bad consequences of the decision from the perspective of all those found on the list. Next, the analysis should be expanded to include any indirect effects not previously considered. In determining the net benefit or cost of a decision, the decision-maker should seek out alternatives that would produce greater amounts of net benefits. If alternatives are found, then the decision-maker should ask some fundamental questions in comparing the alternatives: Which alternative best promotes the common good? Which alternative best respects the rights of the individual? Which alternative best maintains the valuable traits of character espoused in the company’s code of conduct? Finally, the decision-maker must attempt to uncover any dominant considerations that would preclude the action despite the net benefits.

Rights and Duties

While the utilitarian approach focuses upon the net benefits to society, a rights and duties approach views morality from the perspective of the individual. **A moral right of someone creates a correlative moral duty of others not to interfere in the exercise of that right.** John Locke championed the notion of inalienable rights that antecede the social contract that binds people together in a society and binds a government to the people. These inalienable rights, as enunciated in the United States’ foundational documents (Declaration of Independence, Constitution, Bill of Rights) and the French *Rights of Man*, recognize the sanctity of individual autonomy and equality in the pursuit of personal interests. This sanctity of individual freedom is embodied in the U.S. right to vote, right of association, freedom of religion, and right to a free press. In the area of international documents, the **United Nations Declaration of Human Rights** **adopts a basic rights approach** to international human rights concerns. More recently, the United Nations passed a resolution titled the **Declaration on the Right to Development**, which asserts¹ that every person has a basic human right to development. The Declaration places responsibility on individual nations and the international community to ensure that everyone shares in the benefits of development. Article 3 of the Declaration states that countries have “the duty to cooperate in ensuring development and eliminating obstacles to development,” including the formulation of international development policies that promote the “more rapid development of developing countries.” International cooperation is required to provide these countries with “appropriate means to foster their comprehensive development.”

Rights can be seen as dominant considerations that trump a strictly utilitarian calculation of net benefits. Because of the firm belief in individual rights in U.S. political culture, a U.S. company will have difficulty doing business in a culture that openly discriminates against women or minority groups. The developmental benefits of a foreign investment must be weighed against the need to honor and protect the rights of the individual. Ethical issues like this often surface because of the **Theory of Relative Development**,² which questions the appropriateness of applying standards from the home country of a multinational company to a lesser-developed country. Instead, it suggests considering whether the practice or standard would have been acceptable at the time the home country was at a similar stage of development. Past sins, however, may not be sufficient to justify contemporary practices. Sometimes a host country’s standards can be considered inadequate for any level of development. This is the issue in the ethics of wage determination. Do foreign workers have a moral right to a

subsistence wage that is likely to be above the market rate in most developing countries? Is it right for a foreign company to pay a wage far below those paid in their home country and one that fails to improve the standard of life in the impoverished host country?

Another conflict that produces ethical concerns is the **conflict of cultural traditions**, in which an unethical practice in a home country is considered ethically proper in the host country. How does a company contend with the low “glass ceiling” against women that is an overt part of Saudi Arabian culture and religious beliefs? How did the open discrimination against blacks under South African apartheid law influence U.S. investment in that country? The initial response to the subjugation of blacks in South African society was not to boycott foreign investment. Instead, multinational corporations (MNCs) agreed as a group to do business in South Africa but to openly defy the apartheid laws. The hope was that the MNCs could do more good in overturning the apartheid law by working within the system than by outside pressure. Although this approach was eventually abandoned in favor of boycott-embargo, it is an example of moral imagination that overcame the bipolar all-or-nothing approach. It also demonstrates the power of concerted acts of moral behavior. Because the Western companies agreed to defy the laws as a group, the government of South Africa elected not to enforce the laws and punish them.

A form of a rights approach to ethics is **Kantian ethics**. Like the rights approach, this school is deontological in nature. It is premised on the belief that **there are absolute duties (or rights) that cannot be changed despite the consequences created by such a duty**. Immanuel Kant constructed an ethical system that recognized the existence of **absolute moral duties or laws** that he referred to as **categorical imperatives**. These duties were nonnegotiable and were a priori to any utilitarian calculation. One common formulation of the categorical imperative is that human beings can never be used as a “means to an end.” All individuals are to be recognized as equal, rational persons. It is thereby wrong to subject anyone to a risk without their informed consent. Thus, a MNC that constructs a hazardous chemical plant in a developing country has a moral duty to fully disclose the health risks to its host country, the local community, and its foreign workers. The problem with disclosure is that the low level of economic development and per capita income may render the information meaningless. Does the foreign company have to do more than disclose and obey whatever host country regulations may apply? Kantian ethics would hold that we have a universal duty not to intentionally harm one another.

Virtue Ethics

Virtue ethics focuses not upon the morality of an action but **on the moral character or motivation of the actor**. It separates **motives into virtues and vices**. Vices are seen as destructive to human relationships and include selfishness, deceptiveness, and unfairness. In contrast, Aristotle saw virtues as acquired moral traits that allow a person to act according to right and practical reason. This approach is **useful in understanding the importance of corporate culture**. Clearly, **a corporate culture that emphasizes profit at any cost is not conducive to encouraging moral business virtues among the company’s employees**. Virtue ethicists argue that developing morally desirable virtues will help aid moral actions when such decisions need to be made.

Under Aristotelian ethics, developing and acting morally was necessary to reach the state of *eudemonia*, meaning flourishing or happiness. Again, virtue ethics works on the premise that decisions should be made based upon the goal of developing virtues or moral character. Alternatively, someone who is of moral character will make ethically sound decisions. In contrast to virtue ethics, utilitarianism looks to the consequences of a decision or action to determine if the decision is an ethical one. Also, in deontology or Kantian ethics, moral principles are developed and then applied whatever the situation. It is about the development of rules, principles, duties, and rights. In virtue ethics, moral principles are not determined beforehand, as each situation is taken individually and a decision is made generally guided by the desire to be virtuous or benevolent.

Situation Ethics

In situation ethics, the determination of an **ethical decision depends on the context**. There are no universal moral rules, as in Kantian ethics, since each case is unique and deserves a unique solution and, therefore, flexible

guidelines rather than absolute rules are needed. What might be wrong in one situation may be right in a different context or at a different time. Something is good or bad depending whether it helps or hurts people. Thus, situation ethics is more like utilitarianism in that consequences are factored into the decision-making process. The difference is that **the concept of utility under the religious view of situational ethics is love.** Situational ethics is essentially the application of the golden rule “love your neighbor as yourself.” In sum, situation ethics rejects the absoluteness of moral rules found in deontology and uses a different utility metric (love) than utilitarianism.

Ethics of Care

The **ethics of care**³ approach focuses on the **importance of preserving a web of relationships.** A company’s weighing of the benefits and costs of a decision should take into account certain concrete relationships. It is ethically appropriate, for example, for a company to place greater weight on the benefits and costs of a decision to its workers and community. Utilitarianism, deontological, and justice approaches to ethics emphasize the impartiality and equality of all parties. The ethics of care allows for the recognition that we owe an obligation to some more than to others.

The potential influence of this approach can be illustrated by the typical case of plant relocation. The board of directors must decide whether to relocate a long-established and aging plant in its country to a more economically friendly location in a developing country. A utilitarian approach would justify the move purely on efficiency grounds. The rights perspective would recognize the right of an owner to move its business in order to maintain the financial viability of his company. Furthermore, under the employment-at-will doctrine, prevalent in the United States, an employer owes no duty of continued employment to its workers. Finally, since businesses and corporations are organized under the fairly enacted laws of a country, they are entitled to respect as artificial beings, and their fairly arrived-at decisions should not be subject to interference. In contrast, the ethics of care would recognize the special obligation a company has to its workers and community. Thus, the cost of the relocation to the company’s workers and community may override the determinations made under the other approaches.

Integrative Approach to International Business Ethics

The different ethical approaches to business decision-making all offer insight into how to decide or act. An **integrative ethics approach**, **incorporating the best of each**, is especially prudent in international business dealings given the problem of ethical and cultural relativism. Such an approach would weigh the benefits and harms of a decision and compare them to alternatives (utilitarian). It would take into account whether a given action would disrespect the basic rights of persons (rights). It would also judge the distributive effects of the decision and see how the benefits and burdens are ultimately distributed (justice). Finally, it would weigh the impact of the decision upon those who have a concrete relationship with the company (care). The integrative approach would help ensure a fuller stakeholder analysis of international business decisions. The concerns of individuals (rights) and society (utilitarian) are considered both impartially (justice) and preferentially (care). Such an approach can be found in many **corporate codes of conduct**. An examination of Motorola’s approach to ethical conduct illustrates the uses of the various approaches to ethics. The reader can see in its mandates the influences of utilitarian, rights, justice, and virtue-based approaches to ethical decision-making.

Motorola’s corporate code (see Figure 2.1 *Doing Business Internationally*: “Motorola’s Corporate Code”) states that “employees of Motorola will respect the laws, customs, and traditions of each country in which they operate, but will, at the same time, engage in no course of conduct which, even if legal, customary, and accepted in any such country, could be deemed to be in violation of the accepted business ethics of Motorola or the laws of the United States relating to business ethics.” However, cross-cultural misunderstandings still limit the ability of multinational companies to fashion a code of ethics that can be internationally understood and applied.⁴ The problem is that abstract terms, such as *human rights* or *bribery*, have various connotations that depend upon cultural values and local customs. In fact, corporate codes of ethics are not as prevalent in many countries of the world as they are in the U. S.

Even when a code of ethics is implemented, cross-cultural misunderstandings can occur between managers in a host country and those in the home office. Motorola attempts to strike a balance between respecting the customs

Motorola's Approach to Ethical Decision-Making

<i>Code's Language</i>	<i>Ethical Approach</i>
"Look carefully at the consequences of the action"	Utility Calculation
"All parties are to be considered—not just an individual or company and includes both monetary and <i>nonmonetary</i> variables"	Expanded Utilitarian Analysis (direct & indirect effects)
"The action produces more overall good to <i>compensate</i> for harm done"	Utilitarianism
"Give each person his due"	Justice & Fairness
"Respect human and civil rights"	Rights (Deontology)
"Duties are found in law, contracts, policies, and religions, but they are always subject to interpretation"	Duties/Relativism (Respect for Local Culture)
"It is important to recognize the influence of admirable behavior in decision-making such as honesty and courage."	Virtues

Figure 2.1 *Doing Business Internationally*: Motorola's Corporate Code.

and laws of a host country while remaining true to its own code of ethics and that of its home country. Ultimately, this statement directly addresses the notion of ethical relativism in the interpretation of the code. Nonetheless, it firmly obligates its employees to be guided by home country and not host country beliefs. The issue of cross-cultural morality as represented in the divergence between host and home country standards is more fully addressed later in this chapter.

Amoral International Businessperson

Nobel laureate Milton Friedman wrote in 1970 that the only social responsibility of business is to increase profits.⁵ Under Friedman's analysis, corporations have no social conscience and should not be concerned with being good "corporate citizens." In his view, it is wrong for a corporation to spend corporate profits on social or charitable concerns since the practice of social responsibility applies only to individuals and not to corporations. It is the prerogative of the individual stockholder to voluntarily spend his share of the corporate profits on behalf of social ends. From an ethical perspective, corporations need conform only to the **moral minimum**.

The moral minimum, according to Friedman, is simply obeying the "basic rules" or laws of society in the pursuit of greater profits. What are the "basic rules" of society? Should the definition of basic rules be restricted to the mandatory laws of the country? Do you agree with Friedman that a corporation has no social conscience and should not promote desirable "social ends"?

One approach to reconciling these questions is the **myth of the amoral businessperson**. It asserts that **good ethics is consistent with the pursuit of profits**. Moreover, this school of business argues that **good ethical business practices are necessary for long-run profitability**. Francis Fukuyama in his study of why some societies were more prosperous than others isolated the **notion of trust as the crucial factor**.⁶ Under his notion of trust, business is essentially a cooperative venture whose very existence requires ethical behavior. The rational self-interest depicted in Adam Smith's "economic man" results in uncooperative behavior. In fact, the nature of business shows that even people motivated solely by self-interest still have good reason to be ethical in their business dealings.

Merck, an international pharmaceutical company, sees its reputation for ethical behavior as a competitive advantage. Merck's code of ethics is a clear rejection of the amoral-businessperson perspective. Instead, it views a company's function as being a good corporate citizen. In short, profits are important, but not necessarily the determinant factor in corporate decision-making. The Merck company's motto as espoused by its founder states: "We try never to forget that medicine is for people. It is not for profits. The profits follow, and if we remember that, they have never failed to appear. The better we have remembered that, the larger they have been." The next section focuses on the special problems of accountability in the organizational setting.

Organizational Ethics

Organizational ethics can be a crucial problem for the multinational enterprise. How do moral standards, developed in conjunction with personal will or responsibility, apply to corporations? Assuming that organizations are morally responsible, what individuals within the organization should be held accountable for violations of the corporation's moral duties? The traditional view is that those who *knowingly* partake in unethical actions should be held accountable. In the case of insider trading, for example, all those who knowingly give and use inside information are morally responsible. The problem is the fragmentation of responsibility in large organizations. An unethical action may be produced by many loosely connected actors. Some may simply be following organizational rules and may be unaware of the outcome of their contribution to the process; their ignorance may absolve them of moral responsibility.

Hannah Arendt documented the *problem of subordinate responsibility* in her 1963 work *Eichmann in Jerusalem: A Report on the Banality of Evil*. Adolph Eichmann was a typical middle-level bureaucrat in charge of delivering the trains carrying Jews to the death camps. His response to the morally reprehensible nature of his behavior was that he was “just following orders.” Eichmann seemed to possess no ill will for the Jews, but was incapable of thinking from the perspective of another person. His “inability to think [ethically]” was as dangerous as someone acting with evil intent. Viewing an action from the perspectives of different stakeholders inside and outside of the organization will sensitize corporate decision-makers to ethically relevant issues.

In 1994, a group of business leaders introduced the **Caux Round Table Principles for International Business**, which blend the Western concept of the dignity of all human beings with the Japanese concept of *kyosei*—that a primary value of society is working together for common good. The Caux Principles list the factors companies should take into account when making business decisions.

Principle 1 makes it the responsibility of business to go *beyond shareholders toward stakeholders*. Businesses should take into consideration not only the well-being of their shareholders but also that of their customers, employees, suppliers, competitors, and communities.

Principle 2 deals specifically with companies transacting business in a foreign country. It requires that the social and economic impact of business be directed at advancing *innovation, justice, and world community*. Businesses in foreign countries should create productive employment and raise the standard of living of its citizens.

Principle 3, *Business Behavior: Beyond the Letter of Law toward a Spirit of Trust*, admonishes that it may not be appropriate for a company to enforce its rights strictly under the law. In the area of intellectual property rights, disclosure of some information demonstrates a concern for the long-term development of an impoverished country.

Principle 6 makes *respect for the environment* a moral minimum for all international businesses. Environmental protection includes improving the environment, promoting sustainable development, and avoiding the wasteful use of natural resources.

Principle 7, *Avoidance of Illicit Operations*, targets bribery and corruption and their damaging effect on a country's development. The assumption that corporations have social and environmental responsibilities is further recognized in the United Nations Global Impact Program. The Global Impact initiative is a voluntary program that invites companies to commit themselves to protecting the environment, abolishing child labor, and supporting free-trade unions.

Environmental Ethics

Rapid economic development and industrialization comes at a price: harm to the local and world environments. It is important to **balance the goals of industrialization with environmental protection**. For the least developed nations, assistance from the developed world is imperative. Those countries that have successfully evolved from a poor country to a developed country are considered an emerging economy and must themselves ensure a healthy environment for their citizens. Korea, now the 12th largest trading nation in the world, is one such country. It has achieved tremendous economic growth with an annual growth rate of about 8 percent through rapid industrialization at the expense of the environment. In one of its largest industrial centers there is a monument to the country's drive toward industrialization that bears the inscription: “Dark smoke arising from factories are symbols of our nation's growth and prosperity.”⁷

Because of environmental neglect, environmental protection became an important political issue beginning in the 1980s. By 1997, more than 300 nongovernmental organizations (NGOs) had been established, including the Korean Environmental Preservation Association and the Korea Action Federation for the Environment. Eventually, the government began to respond to the people's increased sensitivity to environmental concerns. The country had never had a separate agency assigned to the enforcement of environmental laws. In 1979, the government established the Environmental Administration (EA) to monitor environmental enforcement and duties. This was followed by an amendment to the Korean Constitution giving all citizens a right to a clean and healthy environment. Beginning in the 1990s, Korea began to model its environmental laws after those in the United States. This began with the enactment of the Basic Environmental Policy Act (BEPA) in 1990. At the same time, the EA was elevated to cabinet level as the Ministry of Environment.

The Korean experience shows the importance of public awareness of environmental problems and the instrumental role of NGOs in pressuring the government to act. It is important to realize that economic development and the emergence of strong democratic principles allowed public awareness to flourish. However, major shortcomings remain in Korea's environmental laws. Economic development has been successful in raising the Korean standard of living and in supporting the creation of democratic principles, but at a cost to the environment. The current issue is whether a sufficient amount of the monies produced by its economic expansion will be used to modernize more fully its environmental laws.

Sustainability, Environment, and Human Rights

The notion of sustainability is used in multiple contexts. For example, short termism in management looks to improve profits in the short term and not to the sustainability of profits in the long term. Sustainability has also become intimately connected to the preservation of the environment and protection of human rights in the long term. In addition, environmental issues have now become human rights issues. This section explores the notion of sustainability in the context of the environment and human rights.

The United Nations has established a set of **Sustainable Development Goals (SDGs)** intended to be universal in the sense of embodying a universally shared common global vision of progress toward a safe, just, and sustainable space for all human beings to thrive on the planet. They reflect the moral principle that every country should be regarded as having a common responsibility for playing their part in delivering the global vision. All of the goals and targets contain important messages and challenges for developed and developing countries.

The different goals and targets will however represent different degrees of challenge depending on the present *state of development* of a given country. Much of the international discussion in the formation of the SDGs has naturally and rightly concentrated on the pressing development needs of the developing countries and the support they will need from the international community. Some of the individual goals and targets have been particularly shaped and calibrated to express the needs and aspirations of developing countries; and others express the responsibilities of the developed world to assist the development process in the developing world. What are these sustainability goals, and how do they affect developing countries, especially the least developed countries? A good place to start is the 1992 Rio Declaration on Environment and Development. However, instead of looking at the Rio Declaration directly, the next section will review **Rio Principles +**, as espoused in a 2012 Resolution of the United Nations.

Rio Principles +

The 1992 Rio Declaration on Environment and Development established the "Rio Principles" on environmental protection, and sustainable development was reaffirmed by a Resolution adopted by the General Assembly on July 27, 2012, "The Future We Want."⁸ The following review is a summary of the issues that can be called the "Rio Principles +."

Poverty Eradication

While there has been progress in reducing poverty in some regions, this progress has been uneven and the number of people living in poverty in some countries continues to increase, with women and children constituting the majority of the most affected groups, especially in the least developed countries and particularly in Africa.

Sustainable Agriculture

Reaffirm the right of everyone to have access to safe, sufficient and nutritious food, consistent with the right to adequate food and the fundamental right of everyone to be free from hunger.

Water and Sanitation

Water is at the core of sustainable development as it is closely linked to a number of key global challenges. We therefore reiterate the importance of integrating water into sustainable development.

Energy

Energy plays a critical role in the development process, as access to sustainable modern energy services contributes to poverty eradication, saves lives, improves health and helps to provide for basic human needs. We also recognize that improving energy efficiency, increasing the share of renewable energy and cleaner and energy-efficient technologies are important for sustainable development, including in addressing climate change.

Sustainable Tourism

We encourage the promotion of investment in sustainable tourism, including ecotourism and cultural tourism.

Sustainable Transport

We support the development of sustainable transport systems, including energy-efficient multimodal transport systems, notably public mass transportation systems, clean fuels and vehicles, as well as improved transportation systems in rural areas.

Sustainable Cities

We recognize the need for a holistic approach to urban development and human settlements that provides for affordable housing and infrastructure and prioritizes slum upgrading and urban regeneration.

Health and Population

We are convinced that action on the social and environmental determinants of health, both for the poor and the vulnerable and for the entire population, is important to create inclusive, equitable, economically productive and healthy societies.

Promoting Full and Productive and Decent Employment

We emphasize the need to enhance employment and income opportunities for all, especially for women and men living in poverty, and in this regard we support efforts to provide new job opportunities to the poor in both rural and urban areas, including support to small and medium-sized enterprises. We recognize that workers should have access to education, skills, health care, social security, workers' rights, social and legal protections, including occupational safety and health, and decent work opportunities.

Ocean and Seas

The *United Nations Convention on the Law of the Sea* provides the legal framework for the conservation and sustainable use of the oceans and their resources. We stress the importance of the conservation and sustainable use of the oceans.

We therefore commit to protect, and restore, the health, productivity and resilience of oceans and marine ecosystems and the use of the precautionary approach in the management of activities having an impact on the marine environment.

Precautionary principle states that if an action or policy has a suspected risk of causing harm to the environment or human beings in the absence of scientific consensus of whether the action or policy is not harmful, the burden of proof that it is *not* harmful falls on those taking an action.

Climate Change

We reaffirm that climate change is one of the greatest challenges of our time, and we express profound alarm that emissions of greenhouse gases continue to rise globally. We urge parties to the United Nations Framework Convention on Climate Change and parties to the Kyoto Protocol to fully implement their commitments.

Forests

We call for enhanced efforts to achieve the sustainable management of forests, reforestation, restoration and afforestation, and we support all efforts that effectively slow, halt and reverse deforestation.

Biodiversity

We recognize the severity of the global loss of biodiversity and the degradation of ecosystems, and emphasize that these undermine global development, affecting food security and nutrition, the provision of and access to water and the health of the rural poor and of people worldwide, including present and future generations. We recognize that the traditional knowledge, innovations and practices of indigenous peoples and local communities make an important contribution to the conservation and sustainable use of biodiversity, and their wider application can support social well-being and sustainable livelihoods.

Chemicals and Waste

We recognize that the sound management of chemicals is crucial for the protection of human health and the environment. We are deeply concerned that many countries, in particular the least developed countries, lack the capacity for sound management of chemicals and waste throughout their life cycles. We urge countries and other stakeholders to take all possible measures to prevent the unsound management of hazardous wastes and their illegal dumping, particularly in countries where the capacity to deal with these wastes is limited. We commend existing public–private partnerships, and call for continued, new and innovative public–private partnerships among industry, governments, academia and other non-governmental stakeholders, aiming to enhance capacity and technology for environmentally sound chemicals and waste management, including for waste prevention.

Gender Equality

We reaffirm the vital role of women and the need for their full and equal participation and leadership in all areas of sustainable development. We are committed to equal rights and opportunities for women in political and economic decision-making and resource allocation and to removing any barriers that prevent women from being full participants in the economy.

Host–Home Country Standards

A multinational enterprise is confronted with different standards in the various countries that it does business, and it must resolve whether to apply host or home country standards (health, safety, environmental) to a foreign operation.

It can choose among three approaches. First, it may decide that a company is ethically and legally obligated to apply only host country standards to its activities within that country. One exception is made for home country laws that apply extraterritorially, such as the U.S. **Foreign Corrupt Practices Act (FCPA)**, securities, and antitrust laws. This approach is closely associated with the moral-minimum school of business ethics where complying with applicable law is a company's only moral imperative.

Second, the company may determine that an ethical company should apply the higher standards of its home country's laws and regulations, critical in areas where harm is a foreseeable consequence of the activity. This approach requires that the more stringent environmental, health, and safety regulations found in U.S. law should be used in foreign operations.

The third approach is a variation of the second. This approach asserts that although higher standards are preferred they may not be ethically required in all instances. This approach allows a U.S. company to take into account the stage of development of the host country. Using this approach, an ethical company must answer the following question: Will the application of the more stringent requirements of the home (developed) country be harmful to the host (developing) country or its development? An alternative formulation of this question is whether good consequences from a corporate presence in a country override low or unethical national standards. For example, can the economic benefits of a corporate operation in an impoverished country justify operation in a country that openly discriminates against groups within the population?

There are a number of ways to answer the questions above. One utilizes ethical relativism. It holds that ethics is culture-bound and thus the ethical determination of the host country should be honored. However, it is problematic for a U.S. company to do something considered ethically repugnant by Americans. A second way has been labeled the "Righteous American" perspective, dictating the use of U.S. rules and standards in foreign business operations. The danger of such an approach is that it may diminish the importance of respecting local culture and lifestyles. A third and more radical perspective is that international companies need not follow any ethical rules. Since their competitors may not do so, following high ethical standards would place them at a competitive disadvantage. This perspective was advanced by those critical of the FCPA.

Corruption and Bribery

"Almost a fifth of more than 1,000 executives surveyed by Ernst & Young claimed to have lost business due to a competitor paying bribes; more than a third felt that corruption was getting worse."⁹ The 2014 *Transparency International Corruption Index*¹⁰ shows a number of the U.S. major trading partners are countries that do poorly on the Corruption Index. Out of a possible score of 100 for complete lack of corruption (the first number is rank and the number in parentheses is the country's score out of 100), they include South Korea at 43rd (55),¹¹ Malaysia at 50th (52), Brazil at 69th (43), Italy at 69th (43), India at 85th (38), Philippines at 85th (38), China at 100th (36), Mexico at 103rd (35), Argentina at 107th (34), Indonesia at 107th (34), and Russia at 136th (27). The highest score went to Denmark at 92; the lowest scores to North Korea and Somalia at 8. The top 20 least corrupt countries come mostly from the developed world: Denmark, New Zealand, Finland, Sweden, Norway, Switzerland, Netherlands, Luxembourg, Canada, Australia, Germany, Iceland, United Kingdom, Belgium, Japan, Ireland, and United States. However, Singapore is ranked 7th (84), while the United States ranks 17th with a score of 74.

Beginning with the U.S. enactment of the FCPA in 1978 to the founding of nongovernmental organizations like Transparency International in 1993, and to the creation of the **Organisation for Economic Co-operation and Development's (OECD)** Anti-Bribery Convention in 1997, followed by the enactment of new national anti-bribery laws (UK Bribery Act of 2010), corruption has become a test for a country's standing in the world. Countries feel more and more pressure to rid corruption from international business transactions. The stronger economies have increasingly recognized the harm that corruption has on their countries' well-being.

A few of the harms inflicted by corruption include inefficient government contracting and privatizations, delays in receiving necessary government licenses and approvals, inequality of wealth, damage to the political legitimacy of the government, and slower economic growth.¹² For example, one of the top priorities of President Xi Jinping of China, who came to power in 2013, was to begin the most systematic anticorruption campaign in his country's



Image 2.1 Handshake Bribe.

Sources: Kiev and Eugene Pivovarov, WikiCommons.

history. President Xi Jinping has vowed to prosecute “tigers” (high-level government officials) and “flies” (lower-level officials). New Communist Party spending rules were also adopted to reduce wasteful spending on such items as luxury trips and automobiles, alcohol, and gifts.

Foreign Corrupt Practices Act

The U.S. FCPA prohibits U.S. individuals, companies, and direct foreign subsidiaries of U.S. companies from offering, promising, or paying anything of value to any foreign government official in order to obtain or retain business. The FCPA was intended to have and has had a major impact on the way U.S. companies do business overseas. Since the passage of the FCPA, several firms convicted of bribing foreign officials have been subject to criminal and civil enforcement actions, resulting in large fines, exclusion from federal government contracts, and jail terms for employees and officers (see Figure 2.2 *Focus on Transactions: “Five Elements of an FCPA Offense”* and Figure 2.3 *Comparative Law: “FCPA—Bribery Provisions”*). The FCPA also requires companies whose securities are traded in the United States to meet strict accounting provisions. These provisions require corporations to make and keep books and records that accurately reflect the transactions of the corporation and to devise an adequate system of internal accounting controls.

The international entrepreneur should always be cautioned against activities that involve the corruption of foreign officials. Most national laws outlaw the payment of bribes in order to obtain a service, contract, license, approval, or other regulatory consideration from a government official. Unfortunately, anticorruption laws in some countries are not enforced, and bribes are openly solicited. **Transparency International**, a nongovernmental group of business leaders and former government officials, is dedicated to promoting international business ethics and the elimination of corruption. Its primary concern is the damage that bribery causes to the economic and democratic development of developing countries.

Transparency International has used statistics to link corruption with lost development opportunities such as foreign direct investment. It is important to understand, however, that the definition and practice of bribery varies significantly across different cultures. For example, in the Indonesian concept of *sharism*, a bribe is shared and loses the character of a bribe in the Latin American sense. The Indonesian bribe is best understood as an “express

<p style="text-align: center;">Who?</p> <p>The FCPA potentially applies to any individual, company, officer, director, employee, or agent of a company and any stockholder acting on behalf of a U.S. controlled company. United States parent companies may be held liable for the acts of foreign subsidiaries where they authorized, directed, or controlled the activity in question, as can U.S. citizens or residents who were employed or acting on behalf of such foreign-incorporated subsidiaries.</p>	<p style="text-align: center;">Corrupt Act</p> <p>The FCPA prohibits paying, offering, promising to pay, or authorizing to pay or offer money or anything of value.</p>
<p style="text-align: center;">Knowing Requirement (Corrupt Intent)</p> <p>The person making or authorizing the payment must have corrupt intent and must have intended to induce the recipient to misuse his official position.</p>	<p style="text-align: center;">Recipient</p> <p>The prohibition extends to corrupt payments to a foreign official, a foreign political party or party official, or any candidate for foreign political office.</p>

Figure 2.2 *Focus on Transactions*: Five Elements of an FCPA Offense.

<p>(a) It shall be unlawful for any issuer of securities or for any officer, director, employee, or agent of such issuer or any stockholder thereof acting on behalf of such issuer, to make an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to—(1) any foreign official, (2) any foreign political party or official thereof or any candidate for foreign political office, (3) any person, while knowing that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly, to any foreign official for purposes of—</p> <p>(A) influencing any act or decision of such foreign official in his official capacity</p> <p>(B) inducing such foreign official to use his influence with a foreign government or instrumentality thereof, in order to assist such issuer in obtaining or retaining business for or with, or directing business to, any person;</p> <p>(b) Exception for routine governmental action. Subsection (a) shall not apply to any facilitating or expediting payment to a</p>	<p>foreign official, political party, or party official the purpose of which is to expedite or to secure the performance of a routine governmental action by a foreign official, political party, or party official.</p> <p>(c) Affirmative defenses. It shall be an affirmative defense to actions under subsection (a) that—</p> <p>(1) the payment, gift, offer, or promise of anything of value that was made, was lawful under the written laws and regulations of the foreign official's, political party's, party official's, or candidate's country; or</p> <p>(2) the payment, gift, offer, or promise of anything of value that was made, was a reasonable and bona fide expenditure, such as travel and lodging expenses, incurred by or on behalf of a foreign official, party, party official, or candidate and was directly related to—</p> <p>(A) the promotion, demonstration, or explanation of products or services; or</p> <p>(B) the execution or performance of a contract with a foreign government or agency thereof.</p>
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Figure 2.3 *Comparative Law*: Foreign Corrupt Practices Act—Bribery Provisions.

fee” to move requests to a higher level in order to get them processed more expeditiously. It is important to note that the amount is usually reasonable and somewhat standardized and the money doesn’t remain with the official that received it—it is shared with others in the office. It has been argued that in Latin America low ethical standards in politics have had a strong impact on individuals, companies, and the economic systems. “Deception, bribery, fraud, and dishonest negotiations have been means to succeed in private and public organizations in Latin American countries.”¹³ There is an implication that in order to level the competitive playing field, the foreign businessperson will need to make *facilitation payments* or bribes.

The pressure to give bribes is especially troublesome for the U.S. businessperson because of the severe civil and criminal penalties available through the FCPA¹⁴ The Act applies extraterritorially to foreign activities of U.S. citizens, companies, and foreign entities controlled by them. Furthermore, U.S. companies are liable for bribes made by their foreign agents. Actual knowledge of the bribery is not required. Prosecutors need only prove that the firm should have been aware of a high probability that bribing would occur. Incorporated within the Act are

stringent accounting provisions that require companies doing business abroad to maintain records and auditing controls that provide reasonable assurances that bribing is not occurring. A company will be liable for violating the accounting provisions even if no illegal bribing has occurred. Violations of the statute can result in large fines and imprisonment for up to 20 years for an individual. Despite the severity of the penalties for violating the FCPA, major cases of foreign bribery by American companies continue to persist. See *Focus on Transactions*: “Siemens FCPA Settlement.”

Because of the vagaries of the FCPA, Congress sought to clarify some of its provisions and meanings in order to provide additional guidance, and the **Amendments of 1988** provided more detailed definitions of some of the crucial terms of the FCPA. Of foremost importance, it gave examples of expenditures that would be considered **routine government expenditures**. Fees paid to an official for an action “ordinarily” done in the performance of his official duties are exempted. These include obtaining permits, licenses, or other official documents to qualify a person to do business in a foreign country; processing governmental papers, such as visas and work orders; providing police protection, mail pickup and delivery, or scheduling inspections associated with contract performance or inspections related to transit of goods across the country; providing phone service, power and water supply, loading and unloading cargo, or protecting perishable products or commodities from deterioration; or actions of a similar nature.

The question remains what other payments will be allowed for “actions of a similar nature”? The Amendments provide a possible solution to such uncertainty by allowing a private party to obtain an **Attorney General Opinion**. The Attorney General, after consultation with appropriate departments and agencies of the United States and after obtaining the views of all interested persons through public notice and comment procedures, shall establish a procedure to provide responses to inquiries concerning conformance of an action with the Department of Justice’s enforcement policy regarding the FCPA. The Attorney General is required to issue an opinion within 30 days after receiving a request. The crucial distinction for the determination of whether a payment is “routine” is that between a discretionary act and a clerical one. Therefore, the term “routine governmental action” does not include any decision by a foreign official whether, or on what terms, to award new business. These types of decisions are discretionary in nature, and the payment would be considered a bribe.

The 1988 Amendments state that a minor payment made to “any employee of a foreign government or any department, agency, or instrumentality thereof whose duties are essentially ministerial or clerical” would not be considered a bribe under the FCPA. What is considered a minor payment remains to be determined on a case-by-case basis. As we’re about to see, it is important to note that a Federal Appeals Court in *Lamb v. Philip Morris, Inc.*¹⁶ ruled that the FCPA does not provide a private right of action. Thus, a businessperson cannot bring a lawsuit against a competitor for obtaining a contract in violation of the FCPA. He is limited to bringing the alleged violation to the attention of the Justice Department.

Two other important definitional changes were made by the 1988 Amendments. First, the definition of “foreign official” was broadened to include “any officer or employee of a public international organization.” Second, the “knowing” requirement for criminal liability under the FCPA was substantially modified. Actual knowledge of a bribe is not required. Instead, the government needs to prove only that a party had reason to know that some of its money would be used to bribe a foreign official. A party can be found guilty of bribery if such person is aware that another person is “engaging in such conduct, that such circumstance exists, or that such result is substantially certain to occur.” When knowledge of the existence of a particular circumstance is required for an offense, such knowledge is established if a person is “aware of a high probability of the existence of such circumstance.”

The issue remains what is evidence of “substantial certainty” or “high probability.” The court in *United States v. Liebo* found that evidence of knowledge of bribery can be proven circumstantially. It held that giving airline tickets as a “gift” to a cousin of a foreign official was sufficient to sustain a conviction of a business executive where approval of the foreign official was necessary to obtain contracts. This case illustrates a number of provisions of the FCPA. First, third-party bribery is just as illegal as “direct” bribery. Second, the minor payment or expenditure exception is to be narrowly construed.

The FCPA provisions dealing with “substantial certainty” or “high probability” of **third-party bribery** is illustrated in the *Liebo* case. In that case, should Liebo have been concerned by the fact that the “commission

The joint 2008 DOJ/SEC penalty of \$1.6 billion to resolve corruption-related charges is the largest ever paid. The SEC's complaint alleges that between March 12, 2001 and September 30, 2007, Siemens violated the FCPA by engaging in a widespread and systematic practice of paying bribes to foreign government officials to obtain business. Siemens created elaborate payment schemes to conceal the nature of its corrupt payments, and the company's inadequate internal controls allowed the conduct to flourish. The misconduct involved employees at all levels, including former senior management, and revealed a corporate culture long at odds with the FCPA. During this period, Siemens made thousands of payments to third parties in ways that obscured the purpose for, and the ultimate recipients of, the money. At least 4,283 of those payments, totaling approximately \$1.4 billion, were used to bribe government officials in return for business to Siemens around the world. Among others, Siemens paid bribes on transactions to design and build metro transit lines in Venezuela; metro trains and signaling devices in China; power plants in Israel; mobile telephone

networks in Bangladesh; telecommunications projects in Nigeria; national identity cards in Argentina; traffic control systems in Russia; refineries in Mexico; and mobile communications networks in Vietnam. An additional 1,185 separate payments to third parties totaling approximately \$391 million were not properly controlled and were used for illicit purposes, including commercial bribery. The company's tone at the top was inconsistent with an effective FCPA compliance program and created a corporate culture in which bribery was tolerated and even rewarded at the highest levels of the company. Employees obtained large amounts of cash from cash desks, which were sometimes transported in suitcases across international borders for bribery. Authorizations for payments were placed on post-it notes and later removed to eradicate any permanent record. Siemens used numerous slush funds, off-books accounts maintained at unconsolidated entities, and a system of business consultants and intermediaries to facilitate the corrupt payments. Siemens failed to implement adequate internal controls to detect and prevent violations of the FCPA.¹⁵

Figure 2.4 Focus on Transactions: Siemens FCPA Settlement.

(Criminal Fines of Over \$1.6 Billion.)

agents" were related to the government official or that monies were being deposited into foreign bank accounts? Third-party bribery exists when a company hires another and has "reason to know" that a portion of money would be used to bribe. A third party may be a joint venture partner or an agent. How can one determine if one has "reason to know" of a bribe made by a third party?

Lamb v. Philip Morris, Inc.

915 F.2d 1024 (6th Cir. 1990)

Guy, Circuit Judge. Since we find that no private right of action is available under the Foreign Corrupt Practices Act of 1977 (FCPA), we affirm the dismissal of the plaintiffs' FCPA claim. On May 14, 1982, a Philip Morris subsidiary known as C.A. Tabacalera Nacional and a B.A.T. subsidiary known as C.A. Cigarrera Bigott, SUCS, entered into a contract with La Fundacion Del Nino (the Children's Foundation) of Caracas, Venezuela. The agreement was signed on behalf of the Children's Foundation by the organization's president, the wife of the then President of Venezuela. Under the terms of the agreement, the two subsidiaries were to make periodic donations to the Children's Foundation totaling approximately \$12.5 million dollars. In exchange, the subsidiaries were to obtain price controls on Venezuelan tobacco, elimination of controls on retail cigarette prices in Venezuela, tax deductions for the donations, and assurances that existing tax rates applicable to tobacco companies would not be increased. In the plaintiffs' view, the donations promised by the

defendants' subsidiaries amount to unlawful inducements designed and intended to restrain trade. The plaintiffs further assert that the district court erred in prohibiting them from pursuing a private cause of action under the FCPA.

Although the Foreign Corrupt Practices Act was enacted more than a decade ago, the question of whether an implied private right of action exists under the FCPA apparently is one of first impression at the federal appellate level. The Supreme Court recently explained that: In determining whether to infer a private cause of action from a federal statute, our focal point is Congress' intent in enacting the statute. Our central focus is on congressional intent, "with an eye toward" four factors: (1) whether the plaintiffs are among "the class for whose especial benefit" the statute was enacted; (2) whether the legislative history suggests congressional intent to prescribe or proscribe a private cause of action; (3) whether implying such a remedy for the plaintiff would be consistent with the underlying purposes of the legislative

scheme; and (4) whether the cause of action is one traditionally relegated to state law.

First, the defendants contend, and we agree, that the FCPA was designed with the assistance of the Securities and Exchange Commission (SEC) to aid federal law enforcement agencies in curbing bribes of foreign officials. The authorization of stringent criminal penalties amplifies the foreign policy and law enforcement considerations underlying the FCPA. As such, individual private citizens are not part of a class for whose “especial benefit” the statute was enacted. Second, the availability of a private right of action apparently was never resolved (or perhaps even raised) at the conference that ultimately produced the compromise bill passed by both houses and signed into law. Third, recognition of the plaintiffs’ proposed private right of action, in our view, would directly contravene the carefully tailored FCPA scheme presently in place. Congress recently expanded the Attorney General’s responsibilities to include facilitating compliance with the FCPA. Because this legislative action clearly evinces a preference for compliance in lieu of prosecution, the

introduction of private plaintiffs interested solely in post-violation enforcement, rather than pre-violation compliance, most assuredly would hinder congressional efforts to protect companies and their employees concerned about FCPA liability.

Finally, because the potential for recovery under federal antitrust laws in this case belies the plaintiffs’ contention that an implied private right of action under the FCPA is imperative, we attach no significance to the absence of state laws proscribing bribery of foreign officials. We AFFIRM the district court’s dismissal of the FCPA claim.

Case Highlights

- The main statutory purpose of the FCPA is **pre-violation compliance** and not post-violation persecution.
- There is no implied private cause of action permitted under the FCPA.
- The Justice Department and the SEC are solely responsible for the enforcement of the FCPA.

The type of circumstantial evidence that can be used to satisfy the “reason to know” requirement was illustrated in *SEC v. Tesoro Petroleum Corp.*¹⁷ In that case, a company was prosecuted even though it did not directly pay or authorize any bribes. It hired a foreign agent to obtain contracts from a foreign government. It was alleged to have been guilty of third-party bribery. The evidence included the payment of a commission considerably larger than the market rate, a disproportionately small contract price compared to the commission paid, and a large degree of secrecy including the use of Swiss bank accounts. No written contract was entered into with the foreign agent. U. S. companies are expected to exercise *due diligence* and take steps to ensure they have formed a business relationship with a reputable partner or representative. These parties should be investigated to determine if they are qualified, whether they have ties to the government, the number and reputation of their clients, and their reputation with the U. S. Embassy, local bankers, and other business associates.

The *Tesoro* and *Liebo* cases show that a number of red flags need to be addressed in any company’s FCPA compliance program. These red flags are especially important where express and direct bribery is not present. **Red flags** include **paying a commission substantially higher than the going rate**, the **existence of family or business ties between an agent and government officials**, and **commission payments made in a third country**. Are there any other

United States v. Liebo

923 F.2d 1308 (8th Cir. 1991)

Gibson, Circuit Judge. Richard H. Liebo appeals from his convictions for violating the bribery provisions of the Foreign Corrupt Practices Act and making a false statement to a government agency. The background leading to Liebo’s conviction has all the earmarks of a modern fable. Between January 1983 and June 1987, Liebo was vice-president in charge of the Aerospace Division of NAPCO International,

Inc., located in Hopkins, Minnesota. NAPCO’s primary business consisted of selling military equipment and supplies throughout the world. Liebo flew to Niger to get the President of Niger’s approval of a supply contract. He flew to Niger and met with Captain Ali Tiemogo. Tiemogo was the chief of maintenance for the Niger Air Force. Tiemogo testified that during the trip, Liebo told him that

his company would make “some gestures” to him if he helped get the contract approved. When asked whether this promise played a role in deciding to recommend approval of the contract, Tiemogo stated, “I can’t say ‘no,’ I cannot say ‘yes,’ at that time,” but “it encouraged me.” Following Tiemogo’s recommendation that the contract be approved, the President signed the contract.

Tahirou Barke, Tiemogo’s cousin and close friend, testified that in August 1985 he returned to Niger to be married. After the wedding, he and his wife honeymooned in Paris, Stockholm, and London. He testified that before leaving for Niger, he informed Liebo of his honeymoon plans, and Liebo offered to pay for his airline tickets as a gift. Liebo paid for the tickets, which cost \$2,028. Barke testified that he considered the tickets a “gift” from Liebo personally.

Over a two-and-a-half-year period beginning in May 1984, NAPCO made payments totaling \$130,000 to three “commission agents.” The practice of using agents and paying them commissions on international contracts was acknowledged as proper, legal, and an accepted business practice in third-world countries. NAPCO issued commission checks to “agents,” identified as Amadou Mailele, Tiemogo’s brother-in-law, and Fatouma Boube, Tiemogo’s sister-in-law. At Tiemogo’s request, both Mailele and Boube set up bank accounts in Paris. Evidence at trial established that NAPCO’s corporate president, Henri Jacob, or another superior of Liebo’s, approved these “commission payments.” To obtain foreign military sales financing, NAPCO was required to submit a Contractor’s Certification and Agreement with the Defense Security Assistance Agency. In the Contractor’s certification submitted in connection with the third Niger contract, Liebo certified that “no rebates, gifts or gratuities have been given contrary to United States law to officers, officials, or employees” of the Niger government. Following a three-week trial, the jury acquitted Liebo on all charges except the count concerning NAPCO’s purchase of Barke’s honeymoon airline tickets and the related false statement count.

Liebo first argues that his conviction for violating the bribery provisions of the Foreign Corrupt Practices Act by giving Barke airline tickets for his honeymoon should be

reversed. First, Liebo contends that there was insufficient evidence to show that the airline tickets were “given to obtain or retain business.” Second, he argues that there was no evidence to show that his gift of honeymoon tickets was done “corruptly.” We believe that there is sufficient evidence that **the airplane tickets were given to obtain or retain business. The relationship between Barke and Tiemogo could have allowed a reasonable jury to infer that Liebo made the gift to Barke intending to buy Tiemogo’s help in getting the contracts approved. Accordingly, a reasonable jury could conclude that the gift was given “to obtain or retain business.”**

Next, Liebo contends that his conviction should be reversed because the court erred in the giving of jury instructions distinguishing a “gift or gratuity” from a bribe. Here, the court instructed the jury that the term “corruptly” meant that “the offer, promise to pay, payment or authorization of payment, must be intended to induce the recipient to misuse his official position or to influence someone else to do so,” and that “an act is ‘corruptly’ done if done voluntarily and intentionally, and with a bad purpose of accomplishing either an unlawful end or result, or a lawful end or result by some unlawful method or means.” We agree. A jury may infer a corrupt intent if a payment is given voluntarily or intentionally. **AFFIRMED.**

Case Highlights

- Third-party bribery under the FCPA includes the use of agents to make payments to government officials and indirect payments to persons associated with a government official.
- Merely classifying something as a gift (as in *United States v. Liebo*) or a donation (as in *Lamb v. Philip Morris, Inc.*) is not conclusive in assessing whether it constitutes a bribe.
- Direct evidence of actual intent to give a bribe is not required under the FCPA. (Intent may be inferred from circumstantial evidence.)
- Despite the multimillion-dollar size of the government contracts, two airline tickets satisfies the “anything of value” requirement and is not considered a “minor expense.”

red flags that may indicate the potential for third-party bribery? A company’s compliance program should require any potential agent to disclose past or current ties to government officials, a report on the agent’s character by way of reference checks, and a carefully worded written agreement with the agent. The written agreement should expressly state that the agent is working as an independent agent and is not authorized to make any illicit payments on behalf of the principal. The agreement should contain FCPA-oriented clauses, including a clause that requires the agent to comply with all laws and regulations of both the home and host countries.

Whether a U.S. parent company is liable for the acts of a foreign subsidiary depends on the degree of ownership and control exerted by the parent over its foreign subsidiary. The benchmark for degree of ownership is whether the U.S. company is a majority or minority owner. If it is a majority owner, then it is vicariously liable for the violations of its subsidiary. If it owns less than 50 percent, then it need only make a good-faith effort to have its subsidiary comply with the FCPA. Finally, the FCPA does not distinguish between violations involving direct bribery, third-party bribery, and bribery committed by a controlled subsidiary. In fact, the 1988 Amendments stiffened the fines for violations of any of the bribery provisions. Currently, the FCPA provides for individual criminal fines of \$100,000 and imprisonment of up to five years. A company may be fined up to \$2 million per violation. The Amendments also implemented a new individual civil fine of \$10,000, which cannot be reimbursed by the company.

FCPA Accounting Provisions

Section 102 of the FCPA requires anyone covered by the Act to “make and keep records in reasonable detail, that accurately and fairly reflect the transactions and dispositions of assets.” Failure to do so subjects that person or company to the same types of fines as imposed under the bribery provisions. Thus, a company can violate the FCPA without committing any acts of bribery. The problem with the accounting requirements is that the original Act did not define what is meant by “reasonable.” It does not provide a materiality standard to assist in the determination of what needs to be reported.

The 1988 Amendments defined reasonableness as that exhibited by the “prudent person.” Therefore, a company is not expected to show an unrealistic degree of exactitude. Implied in the notion of the prudent person is the use of a benefit–cost approach. Therefore, the accounting requirements are satisfied if the system of internal accounting controls is sufficient to provide reasonable assurance that (1) transactions are executed in accordance with management’s specific authorizations, (2) transactions are recorded to permit preparation of financial statements in conformity with generally accepted accounting principles, (3) access to assets is permitted only with specific management authorization, and (4) accountability for assets is reviewed at reasonable intervals. Under the original act a company could technically be held criminally liable for inadvertent errors. The 1988 Amendments limited criminal liability under the accounting provisions to those who *knowingly* falsify records.

OECD Convention on Combating Bribery

The magnitude of foreign bribery has resulted in some recent movement at the international and regional levels. In 1988, the U.S. Congress directed the President to commence negotiations in the OECD to obtain agreement among its members on anti-bribery provisions. On February 15, 1999, the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions went into effect. The OECD Convention sets forth the following goals:

- to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries, while maintaining financial stability, and to contribute to the development of the world economy;
- to contribute to sound economic expansion in member countries as well as nonmember countries in the process of economic development;
- to contribute to the expansion of world trade on a multilateral and nondiscriminatory basis in accordance with international obligations.

The OECD provides a venue for countries to develop economic and social policies. Even though all countries have laws that make the bribery of officials a crime, only the FCPA is applied extraterritorially to the bribery of foreign officials. The relative success of the FCPA, the growth of the global marketplace, and the recognition of the economic costs to the bribe-giver and to foreign economies provided the impetus for the OECD Convention.

Before the adoption of the OECD Convention on Bribery, a number of predecessor acts were adopted. In 1996, for example, the OECD passed a resolution on the *Tax Deductibility of Bribes to Foreign Public Officials*. Incredibly, a number of countries, such as France, Germany, Norway, and Denmark, had previously allowed for the deductibility of bribes paid as a cost of doing business. In order to study issues of corruption, the OECD has established the Development Centre on Corruption. The major focus of the Centre is to assist developing countries in the fight against corruption.

The Convention provides a framework and guidance to signatories regarding the steps to be taken to combat bribery of their public officials. It defines public officials broadly to include public agencies, public enterprises, and public international organizations. Like the FCPA, it adopts the extraterritorial approach to the international bribery of foreign government officials. It mandates that countries prosecute their nationals for offenses committed abroad. In the accounting area, it requires that each signatory enact “dissuasive civil, administrative, or criminal penalties for such omissions and falsifications in respect of the books, records, accounts, and financial statements.” Companies will be required to disclose, on their financial statements, any potential liabilities under the act that rise to the level of a material contingent liability.

The United States is a member of the OECD and is bound by its new Bribery Convention. The 1998 Amendments to the FCPA recognize the newly enacted OECD Convention on Combating Bribery. The Amendments require the Secretary of Commerce to submit a report to Congress of the following information: (1) a list of the countries that have ratified the Convention and a list of countries where the Convention has entered into force; (2) a description of domestic laws enacted by each party to the Convention that implement commitments under the Convention; (3) an assessment of the measures taken by each party to the Convention during the previous year to fulfill its obligations under the Convention; and (4) an explanation of the domestic laws enacted by each party to the Convention that would prohibit the deduction of bribes in the computation of domestic taxes. Under item (3), foreign countries are to be evaluated by the degree that they enforce their domestic anti-bribery laws, their efforts to promote public awareness of the evils of corruption, and their effectiveness in monitoring and enforcement.

UK Bribery Act 2010

The UK Bribery Act covers four distinct “categories of offenses: (1) bribing another person; (2) taking bribes; (3) bribing foreign public officials; and (4) the failure of a commercial organization to prevent bribery.”¹⁸ Just as the FCPA, the UK Bribery Act of 2010 “applies extraterritorially, reaching any individual ‘closely connected’ with the United Kingdom and, with respect to the corporate offense of failing to prevent bribery, any commercial organization that carries on a business or part of a business in the United Kingdom.” The UK Ministry has provided six guiding principles¹⁹:

(1) *Proportionate Procedures*: “A commercial organisation’s procedures to prevent bribery by persons associated with it are proportionate to the bribery risks it faces and to the nature, scale, and complexity of its activities.”

(2) *Top-Level Commitment*: “The top-level management of a commercial organisation are committed to preventing bribery by persons associated with it. They foster a culture within the organisation in which bribery is never acceptable.”

(3) *Risk Assessment*: “The commercial organisation assesses the nature and extent of its exposure to potential external and internal risks of bribery on its behalf by persons associated with it. The assessment is periodic, informed, and documented.”

(4) *Due Diligence*: “The commercial organisation applies due diligence procedures, taking a proportionate and risk based approach, in respect of persons who perform or will perform services for or on behalf of the organisation, in order to mitigate identified bribery risks.”

(5) *Communication and Training*: “The commercial organization seeks to ensure that its bribery prevention policies and procedures are embedded and understood throughout the organisation through internal and external communication, including training that is proportionate to the risks it faces.”

(6) *Monitoring and Review*: “The commercial organisation monitors and reviews procedures designed to prevent bribery by persons associated with it and makes improvements where necessary.”

The UK Serious Fraud Office is assigned the tasks of investigation and enforcement, as well as providing additional guidelines and policy statements. Its policy is that facilitation payments are bribes and should be seen as such. It gives as an example where a government official is given money or goods to speed up the performance of an existing duty. This is likely not an illegal bribe under the routine “government expenditure exception” of the FCPA. However, the UK Act recognizes the “business expenditure” as excusable payments, such as bona fide hospitality or promotional or other legitimate business expenditures. This is akin the FCPA’s “bona fide expenditure” exception.

As is seen with U.S Federal Sentencing Guidelines for Organizations (see below), corporate self-reporting can benefit the company accused of violating the Bribery Act and may prevent a prosecution of their violations: “The fact that a corporate body has reported itself will be a relevant consideration to the extent set out in the *UK Guidance on Corporate Prosecutions*.” That Guidance explains that for a self-report to be taken into consideration it must form part of a “genuinely proactive approach adopted by the corporate management team when the offending conduct is brought to their notice.” Self-reporting is no guarantee that a prosecution will not follow.²⁰

Anti-Corruption Clause

The ICC (International Chamber of Commerce) Anti-Corruption Clause²⁷ incorporates ICC Rules on Combating Corruption (2011) into a commercial contract. Inclusion in a contract demonstrates a party’s commitment to complying with ICC Rules on Combating Corruption and to maintaining a corporate anti-corruption compliance program. It further preserves trust between parties and prevents corruption in both the negotiation and performance of contracts. The **corruption clause** and an anti-corruption program are important given the global supply chain. This is especially important when a company’s home country prohibits the giving of bribes, as does the American FCPA, which prohibits third-party bribery. If the party allegedly violating the ICC Rules on Combating Corruption does not remedy the situation within a reasonable period of time or if no such remedy is possible, and no defense of adequate anti-corruption preventive measures is effectively invoked, the other party will have the right to terminate the contract.

Corrupt practices include bribery in connection with public or private procurement contract awards, regulatory permits, taxation, customs, and judicial and legislative proceedings; extortion and solicitation; trading in influence; and laundering the proceeds from corrupt practices.

On the issue of gifts and hospitality, the ICC recommends that enterprises establish procedures to ensure that they (1) comply with the law; (2) are reasonable and bona fide; (3) do not affect (or appear to affect) the recipient’s independence of judgment toward the giver; (4) are not contrary to the known provisions of the recipient’s code of conduct; and (5) are offered or received neither too frequently nor at an inappropriate time.

Article 2 of the ICC rules deals with the issue of third-party bribery. Companies often hire third parties, such as agents, consultants, sales representatives, customs agents, resellers, subcontractors, franchisees, lawyers, accountants, or similar intermediaries. The company should instruct third parties that they are engaged (1) not to commit any act of corruption on behalf of the company; (2) not to use the company as a conduit for any corrupt practice; (3) that the third party’s hiring is only to the extent appropriate for the regular conduct of the company’s business; and (4) that the company will not pay them more than what is appropriate for their legitimate services.

United States Federal Sentencing Guidelines for Organizations

Organizations, like individuals, can be found guilty of criminal conduct, and the measure of their punishment for felonies and misdemeanors is governed by Chapter Eight of the Sentencing Guidelines. While organizations cannot be imprisoned, they can be fined, sentenced to probation for up to five years, ordered to make restitution and issue public notices of conviction to their victim, and exposed to applicable forfeiture statutes. The most commonly occurring offenses are fraud, environmental waste discharge, tax offenses, antitrust offenses, and food and drug violations.²¹ The United States’ **Federal Sentencing Guidelines for Organizations**, which became effective on

November 1, 1991, fundamentally altered the approach to organizational accountability. Previously, enforcement actions relating to crimes committed in the corporate context were directed only against the employees responsible for the act. Under the guidelines, the corporate or organizational entity can be held vicariously liable for the criminal acts of its employees. The guidelines also allow for the mitigation of fines for those companies that demonstrate **due diligence** in attempting to prevent misconduct. They provide for more lenient treatment of corporate executives who had implemented an ethics program.

Assessment of Criminal Penalties and Importance of Effective Compliance Programs

Criminal liability can attach to an organization whenever an employee of the organization commits an act within the apparent *scope of employment*, even if the employee acted directly contrary to company policy and instructions. An entire organization, despite its best efforts to prevent wrongdoing in its ranks, can still be held criminally liable for any of its employees' illegal actions. Consequently, when the U.S. Sentencing Commission promulgated the organizational guidelines, it attempted to alleviate the harshest aspects of this institutional vulnerability by incorporating into the sentencing structure the preventive and deterrent aspects of systematic compliance programs. The Commission did this by mitigating the potential fine range, in some cases up to 95 percent, if an organization can demonstrate that it had put in place an effective compliance program. This mitigating credit under the guidelines is contingent upon *prompt reporting* to the authorities and the *non-involvement of high level personnel*²² in the actual offensive live conduct. See Figure 2.5 *Focus on Transactions*: "Case Example: Fines under the Federal Sentencing Guidelines for Organizations."

The above example shows how mitigating and aggravating factors can dramatically affect the fine that is assessed. Another example involved a company convicted of mail fraud for systematically overcharging customers for the costs of repair for damages to its rental automobiles. It was determined that the company fines ranged from \$685,000 to \$54.8 million. The exact amount of the fine is dependent on the existence of mitigating factors recognized under the Federal Sentencing Guidelines for Organizations. Figure 2.6 shows the seven criteria for establishing an effective compliance program.

	<i>Maximum</i>	<i>Minimum</i>
Existence of compliance program, self-reporting crime, cooperation with government investigation	\$2.74 million	\$685,000
Compliance program only	\$10.96 million	\$5.48 million
No program, reporting, or cooperation	\$27.4 million	\$13.7 million
No program, reporting, or cooperation, and involvement by high-ranking personnel	\$54.8 million	\$27.4 million

Figure 2.5 *Focus on Transactions*: Case Example: Fines under the Federal Sentencing Guidelines for Organizations.²³

Establish Standards and Procedures to Prevent and Detect Criminal Conduct	***
Oversight by High-Level Personnel	***
Due Care in Delegating Discretionary Authority	***
Effective Communications at all Levels	***
Reasonable Steps to Achieve Compliance (systems for monitoring, auditing, and reporting wrongdoing without fear of reprisal)	***
Consistent Enforcement and Disciplinary Mechanisms	***
Reasonable Steps to Prevent Recurrence of a Violation	***

Figure 2.6 *Doing Business Internationally*: Seven Criteria for an Effective Compliance Program.

The criminal statute provides the minimum and maximum “base” penalties for illegal conduct. Chapter 8 of the Guidelines then provides factors that are used to increase or decrease the penalties.²⁴ For example, in the case of an organization convicted of three felony counts related to a \$200,000 fraud, the maximum fine authorized by statute will be \$500,000 on each count, for an aggregate maximum authorized fine of \$1,500,000.

The fine range is based on the seriousness of the offense and the culpability of the organization. The seriousness of the offense generally will be reflected by the greatest of the pecuniary gain, the pecuniary loss, or the amount in a guideline offense level fine table. Culpability generally will be determined by six factors that the sentencing court must consider. The four **factors that increase the ultimate punishment of an organization** are: (1) the involvement in or **tolerance of criminal activity**, (2) **prior history** of the organization, (3) **violation of an order**, and (4) **obstruction of justice**; The two **factors that mitigate the ultimate punishment of an organization** are: (1) existence of an **effective compliance and ethics program** and (2) **self-reporting, cooperation, or acceptance of responsibility**. Section 8C2.5 provides for calculating a culpability score to determine the appropriate penalty. The calculation begins at 5, and then points are added based upon a 5-point scale for six factors: (1) involvement or tolerance in criminal activity; (2) prior history; (3) violation of an order; (4) obstruction of justice; (5) effective ethics and compliance program; and (6) self-reporting, cooperation, and acceptance of responsibility. Chapter 8 (Section 8C4.1) allows penalties to be lessened if “the defendant has provided substantial assistance in the investigation or prosecution of another organization that has committed an offense, or in the investigation or prosecution of an individual not directly affiliated with the defendant who has committed an offense, the court may depart from the guidelines.”

The importance of these Guidelines has increased with a recent Delaware court decision that held that corporate directors could be personally liable for subordinates’ wrongdoing if they had failed to establish an ethics program. In short, the guidelines “reward organizations for establishing a legal and ethical compliance program.”²⁵ By law, a company’s penalties for violating the law are adjusted based upon the degree of cooperation exhibited by the company during the government investigation. The penalties can also be reduced if the company had an existing compliance program (see Figure 2.6 *Doing Business Internationally*: “Seven Criteria for an Effective Compliance Program”), along with exhibiting due diligence in policing the program. It is in a company’s best interest to develop a compliance program in such areas as the FCPA, export regulations, environmental compliance, and health and safety laws.

The base or minimum fines to be assessed under the Guidelines range from \$5,000 to \$72.5 million. The levels of base fines are based upon two calculations: the seriousness of the offense and the culpability of the organization. Some of the offenses targeted by the Guidelines include customs violations, bid rigging, fraud, antitrust violations,

Using the culpability score from §8C2.5 (Culpability Score) and applying any applicable special instruction for fines in Chapter Two, determine the applicable minimum and maximum fine multipliers from the table below.

<i>Culpability Score</i>	<i>Minimum Multiplier</i>	<i>Maximum Multiplier</i>
10 or more	2.00	4.00
9	1.80	3.60
8	1.60	3.20
7	1.40	2.80
6	1.20	2.40
5	1.00	2.00
4	0.80	1.60
3	0.60	1.20
2	0.40	0.80
1	0.20	0.40
0 or less	0.05	0.20

Figure 2.7 Sentencing Guidelines Multipliers.

§8C2.6. Minimum and Maximum Multipliers.

transportation of hazardous materials, environmental crimes, commercial bribery, and copyright infringement. Culpability factors include history of past infractions and the rank of the employees within the company. Also, the penalty multiplier based upon the culpability score increases the larger the company and the higher the rank of the employee involved in the misconduct. The Guidelines also expressly recognize mitigating factors that can result in the lessening of the punishment. These include the implementation of an effective compliance program, self-reporting of infractions, and cooperating with the government investigation.

An example of the use of an effective compliance system would be the improvement of a company's global working conditions. The compliance program would specifically state the criteria to be addressed such as the nonuse of forced labor, controlled use of child labor, the implementation of minimum health and safety standards, maximum working hours, payment of a "living wage," and antidiscrimination policies. The implementation of customized standards and third-party verification are essential to a compliance program with these types of objectives.

Human Rights Violations

This section begins with the central premise that it is always unethical to violate an individual's human rights. The key issues are what constitutes a human right and are there any exceptions that would justify a violation of a human right? The first part of the question relates to whether there are differences between "human rights" and "fundamental rights." There is general agreement on a set of "core" human rights, such as freedom of religion, right to due process when accused of a crime, and the equality of all human beings. Modern "rights" documents have greatly expanded the list of human rights to include broader fundamental rights, such as the right to work and the right to a "living wage." The United Nations Universal Declaration of Human Rights is considered a fundamental human rights document that sets the scope of human rights and issues relating to human rights violations.

Universal Declaration of Human Rights

(Adopted by the United Nations General Assembly on December 10, 1948)

Article 2 states that "everyone is entitled to certain rights and freedoms, without distinction of any kind, such as race, color, sex, language, religion, political or other opinion, national or social origin, property, birth, or other status." This nondiscrimination principle applies to the enumerated rights listed in the declaration. Article 3 provides the general recognition that "everyone has the right to life, liberty, and security of person." Other articles provide specific rights, including the right against torture or degrading treatment (Article 5), right to recognition everywhere as a person under the law (Article 6), right to an effective remedy for acts violating fundamental rights (Article 8), right to a fair and public hearing by an impartial tribunal (Article 10), freedom of movement (Article 13), right to own property (Article 17), freedom of religion (Article 19), right to take part in government (Article 21), and the right to social security, including "the economic, social, and cultural rights indispensable for his dignity" (Article 22). In the area of nondiscrimination, Article 7 states that: "all are entitled to equal protection against discrimination." Article 23 provides that "everyone, without any discrimination, has the right to equal pay for equal work." Quality of life and a living wage are considered fundamental human rights. Article 23 states that everyone has a right to work, to just and favorable working conditions, to a just remuneration ensuring for himself and his family "an existence worthy of human dignity." Article 25 further defines just remuneration as one that provides a "standard of living adequate for health and well-being, including food, clothing, housing and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, or old age."

For information on another fundamental human rights doctrine, the European Union (EU) **Charter of Fundamental Rights**, which was enacted as EU law in 2009, see Chapter 8, "European Union." Compare the 1948 United Nations Declaration with the 2009 EU Charter to see the broadening of the scope of human or fundamental rights.



Image 2.2 Eleanor Roosevelt.

Source: UN Human Rights, WikiCommons.

Bhopal Disaster

On December 2 and 3, 1984, the Union Carbide India Limited (UCIL) pesticide plant in Bhopal, India exploded, exposing a half-million people to toxic gases and chemicals. The large size of the number of people exposed was due to the construction of “shanty towns” located next to and around the plant. It has been estimated that about 16,000 people have died due to gas-related illnesses, and more than 100,000 have experienced serious medical conditions. The parent company, Union Carbide Corporation (UCCorp) of the U.S., owned 50.9 percent, with the Indian government and Indian nationals owning 49.1 percent. UCCorp chairman Warren Anderson, together with a technical team, immediately traveled to India. Upon arrival, however, Anderson was placed under house arrest. UCCorp also organized a team of international medical experts, as well as supplies and equipment, to work with the local Bhopal medical community.

UCIL’s plant was managed by an entirely Indian workforce and was subject to safety inspections by Indian government agencies. The Indian government enacted the Bhopal Gas Leak Act to gain status as the legal representative of all the victims. India brought a lawsuit against UCCorp in the U.S. The U.S. District Court held that Bhopal, India was the proper venue. The U.S. Federal Court of Appeals affirmed, stating that UCIL was a “separate entity (from UCCorp), owned, managed and operated exclusively by Indian citizens in India.” UCCorp eventually agreed to pay a \$470 million settlement. The facts of what caused the disaster are still being debated. Nevertheless, it has become a classic ethics case study. The specific facts of the case have been altered in some case studies, but the variation of facts is useful in developing additional hypothetical case studies. A number of “facts” are provided here to encourage discussion of their importance to legal and ethical issues related to the disaster. The facts should be applied to the questions presented in Figure 2.8 *Focus on Transactions*: “Ethical Issues Raised by Bhopal Disaster.”

Fact 1: The plant was under-maintained with decaying facilities, a weak attitude toward safety, and an under-trained workforce.

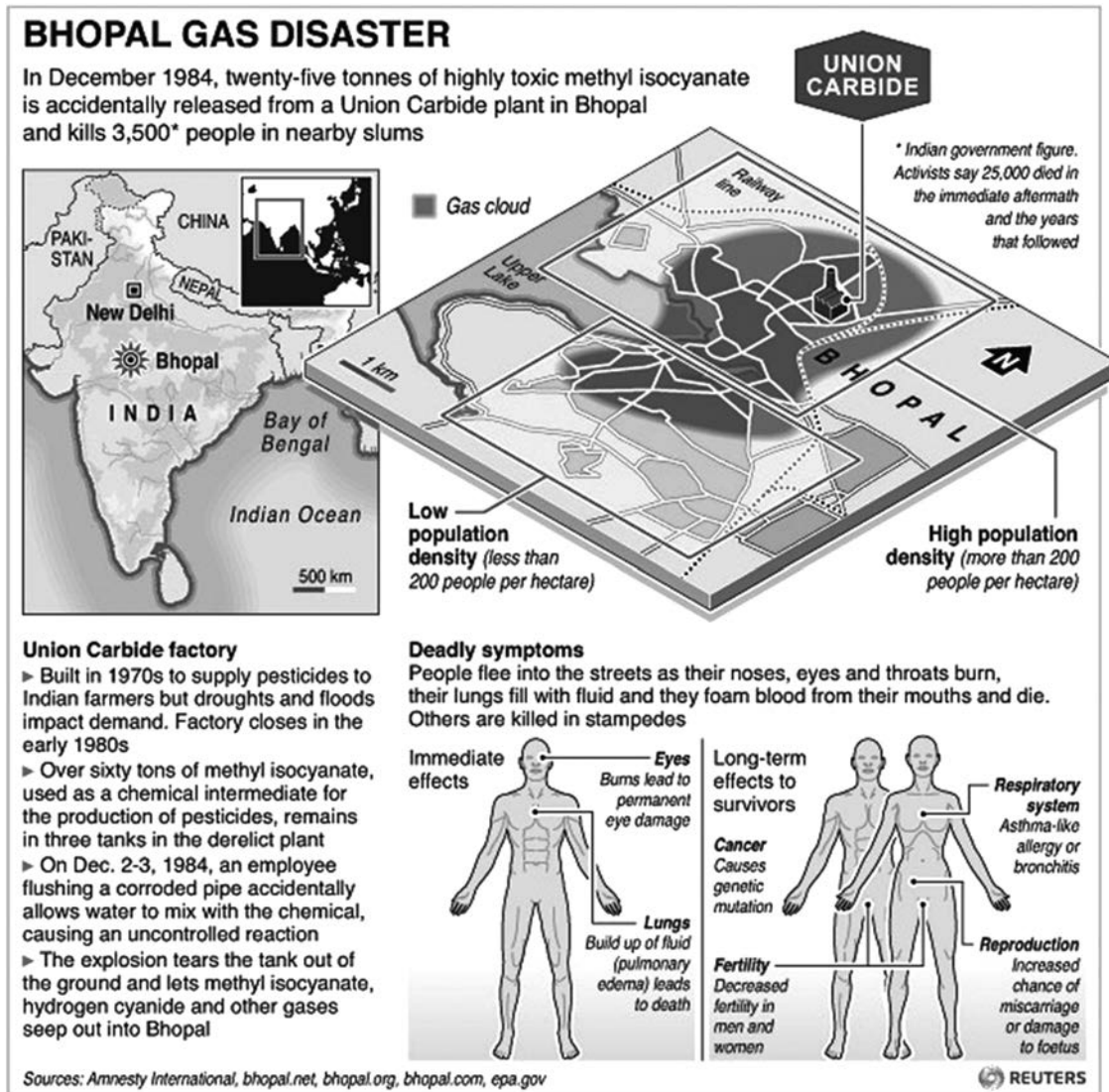


Image 2.3 Bhopal.

Fact 2: Management and the local government underinvested in safety and allowed for a dangerous working environment.

Fact 3: "Serious communication problems and management gaps between Union Carbide and its Indian operation," characterized by "the parent companies hands-off approach to its overseas operation" and "cross-cultural barriers."

Fact 4: There was no disaster plan in place at the time of the disaster.

Fact 5: The UCCorp chairman was released within 24 hours of his arrest on bail of \$2,100 and was flown out on an Indian government plane.

Fact 6: Chemicals abandoned at the plant continue to leak and pollute the groundwater; whether the chemicals pose a health hazard is disputed.

- | | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> • To what extent should multinational companies maintain identical standards at home and abroad, regardless how lax the laws are in the host country? • How wise are laws that require plants to be staffed entirely by local employees? • What is the responsibility of corporations and governments in allowing the use of otherwise safe products that become dangerous because of local conditions (e.g., proximity of residences in Bhopal)? • Should certain kinds of plants not be located in developing nations? Was the true moral responsibility for Bhopal that of the Indian government because of its local participation and | <ul style="list-style-type: none"> management requirements (which reduce parent company control and the flow of technical expertise)? • Did the parent company have an ethical responsibility to protect workers and the public? Does this responsibility have priority over the duty to earn a profit? • Does the absence of sufficient government regulations excuse the parent company from any legal responsibility? • Did the parent company have a social responsibility not to locate a plant in a foreign country where it did not have sufficient control? Should a parent company be held liable as parents are held liable for the damage done by their children? |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

Figure 2.8 *Focus on Transactions*: Ethical Issues Raised by Bhopal Disaster.

The categorical imperative requires that a MNC do more than merely disclose or comply with host country regulations. UCCorp's arguments that it was not morally responsible for the Bhopal disaster²⁶ is difficult to support under the duty not to harm. Union Carbide argued that it lacked sufficient control over the safety and operations of the Indian plant. It argued that its independent subsidiary, which was 49 percent owned by the Indian government and citizens, was responsible for the plant. Furthermore, it argued that it had no responsibility for the safety of the plant because all management and safety personnel were Indian and the Indian government controlled safety inspections and standards. In fact, the blueprints for the Bhopal plant provided by Union Carbide were rejected in favor of an Indian-designed alternative. Does the forced abdication of all control by Union Carbide to the Indian government absolve it of moral responsibility for the accident, or is it simply an excuse used by the parent company to avoid liability? Critics would argue that such companies have a moral responsibility not to locate hazardous plants in a foreign country unless they retain sufficient control. Should the fact that the pesticides produced by the Bhopal plant helped feed millions of Indians be entered into this ethical equation? The issues presented in the Bhopal Case Study will be revisited in the case study at the end of the chapter: "Choosing Values: Public-Private Relationships in a Global Economy."

International Standards

Standards refer to government regulations pertaining to labor, health, safety, and environmental concerns. A variety of "voluntary standards" also exist, advanced by either trade associations or NGOs. The **International Labour Organization** is an example of a nongovernmental agency that publishes standards for the workplace. Standards to ensure adequate levels of quality, labor, and environmental sensitivity in the production and marketing of goods and services are important and evolving. The wide variety of national standards in these areas produces a number of problems. First, it promotes the lowest common denominator in the production of goods. Companies that are motivated only by short-term profits will attempt to cut costs by searching for countries with the most lax environmental and labor laws. Second, a company seeking to market its products internationally has to contend with differing standards that may act as barriers to importing a company's goods into various countries.

One solution to both problems has been the development of international standards, which can both reduce barriers to trade and ensure minimum levels of quality, labor, and environmental compliance. The problem of uneven standards across different countries can be resolved through the harmonization of standards. Alternatively, international standards can act as setting minimal or aspirational levels of compliance. International standards continue to grow in numbers and significance. However, each country has the sovereign right to set their own environmental, health, quality, and safety standards. So, since the goal of complete harmonization is unrealistic, countries will continue to have different levels of standards. An important trend is the voluntary adoption of standards that will be recognized as socially responsible. Companies are incentivized to obtain standard

certifications to satisfy social responsibility codes, increase the marketability of their goods, and to satisfy national standards requirements or to smoothly import goods into different countries.

Examples of international standards are those issued by the **International Organization for Standardization (ISO)**. The ISO was established in 1947 and has 165 member countries. Companies who want to be ISO-certified voluntarily apply their standards, and some countries have adopted ISO standards as national law. Thus, companies have a number of purposes for obtaining ISO certifications including: (1) the World Trade Organization requires members to adhere to international standards of the type developed by ISO, (2) standards help companies save on costs, (3) standards reassure customers about the trustworthiness of the company and its products, and (4) standards have been shown to contribute to economic growth.²⁸ Figure 2.9 lists the different types of ISO standards that are available.

The mission of ISO is to promote the development of standardization and related activities in the world in order to facilitate the international exchange of goods and services and to develop cooperation in the spheres of intellectual, scientific, technological, and economic activity. International standardization is well-established for many technologies in such diverse fields as information processing and communications, textiles, packaging, distribution of goods, energy production and utilization, shipbuilding, banking, and financial services. It will continue to grow in importance for all sectors of industrial activity for the foreseeable future.

ISO have developed hundreds of codes besides the ones listed in Figure 2.9. For example, the ISO has developed international codes for country names, currencies, and languages that have helped to eliminate duplication and incompatibilities in the collection, processing, and dissemination of information. As resource-saving tools, universally understandable codes play an important role in both automated and manual documentation. The ISO and many of its members are actively involved in consulting and training services, which include seminars on the application of standards in quality assurance systems, technical assistance to exporters concerning standards requirements in other countries, workshops on consumer involvement in standardization, and conferences and symposia covering recent developments in testing and certification.

The most recognized international standard is the **ISO 9000 (Quality Management)**. The purpose of the ISO 9000 Standard is to facilitate international commerce by providing a single set of quality standards that people everywhere recognize and respect. The ISO 9000 Standards apply to all types of organizations in all kinds of areas. The ISO provides guidelines for developing a quality management system. To become certified, an independent auditor must verify that the company's factory, laboratory, or office meets ISO quality standards. They will then issue an official certificate and record the company's name in their registry. The company can then promote the quality of its products and services as ISO 9000 certified.

ISO 14000 (Environmental Management) is a series of international, voluntary environmental management standards. The ISO 14000 series of standards effectively addresses the needs of organizations worldwide by providing a common framework for managing environmental issues. ISO 14000 standards require a company to establish an environmental management system (EMS). An EMS enables an organization of any size or type to control the impact of its activities, products, or services on the natural environment. The benefits of installing an EMS include: (1) assuring customers of a commitment to demonstrable environmental management, (2) maintaining good public/community relations, (3) obtaining insurance at reasonable cost, (4) reducing incidents that result in liability, and (5) facilitating the attainment of permits and authorizations. The standards in the ISO 14000 series fall into two major groups: organization-oriented standards and product-oriented standards. Organization-oriented standards provide comprehensive guidance for establishing, maintaining, and evaluating

ISO 9000: Quality Management	ISO 26000: Social Responsibility
ISO 14000: Environmental Management	ISO 27001: Information Security
ISO 19600: Compliance Management	ISO 50001: Energy Management
ISO 22000: Food Management	ISO 31000: Risk Management

Figure 2.9 ISO Standards.

an EMS. Product-oriented standards are concerned with determining the environmental impact of products and services over their life cycles and include environmental labeling and declarations. Product-oriented standards will help an organization communicate specific environmental information to consumers and other interested parties.

The ISO has been successful in raising the level of awareness in areas of product quality and the environment. Its certifications under ISO 9000 and ISO 14000 provide both practical and ethical benefits to companies. From a practical perspective, products with these certifications are likely to find fewer obstacles in the area of importation. Most countries recognize the significance of the ISO certifications. From a business perspective, ISO certifications can be used by companies as evidence of their commitment to producing quality products and to being an environmentally conscious company.

Some of the ISO standards do not provide certification, but serve as guides for improvement in certain areas, such as Compliance Management (**ISO 19600**) and Social Responsibility (**ISO 26000**). ISO 19600 not only addresses risks and legal requirements but is also intended to meet the needs of stakeholders. It deals with both mandatory requirements (court judgments, laws, permits) and voluntary principles (environmental commitments, industry standards). Because they are guidelines rather than requirements, there is no official ISO 19600 certification. It is simply intended to assist organizations in improving their approaches to compliance management. This allows for small- and medium-sized organizations to adapt the solutions to their systems. Leadership can support compliance management by: (1) establishing and upholding organizational values, (2) ensuring that the compliance management system is consistent with the organization's strategy, (3) ensuring that adequate resources are allocated and assigned appropriately, and (4) clearly communicating the compliance management system to all stakeholders.

ISO 26000's (Social Responsibility) intent is to use social responsibility to improve lives of workers, natural environments, and communities. It lays the basis for a common understanding of social responsibility, as well as promoting communication, transparency, and trust among stakeholders. The seven principles of ISO 26000 include accountability; transparency; ethical behavior; respect and consideration for all stakeholders; respect for rule of law; respect for international norms of behavior; and respect for human rights. Over 60 countries have adopted the Standards.

The activities of the EU deserve special attention. EU requirements include the placement of a **CE mark** by the manufacturer on all regulated products. Importers who obtain the CE mark will be guaranteed access to the markets of all EU members. The CE mark asserts that the product meets mandatory health, safety, and environmental requirements of the EU. A newer development is the establishment of a voluntary mark known as the **EU Ecolabel**. Products without the Ecolabel may still enter the EU, but the label, if used, replaces the existing national equivalents. In order to obtain an Ecolabel, the manufacturer must show that its products are less harmful to the environment than other similar products.

The Council on Economic Priorities Accreditation Agency has used the ISO model to develop a **Social Accountability Standard**. The SA 8000 standard insures that a company and its suppliers provide an equitable and safe workplace for their employees. The SA 8000 certification requires a company to restrict the use of child or forced labor, to respect the right of workers to unionize, to limit the workweek to 48 hours, to provide a safe working environment, and to pay a living wage that meets the basic needs of the workers. The SA 8000 allows companies to demonstrate a commitment to international human rights standards. Firms that wish to avoid bad publicity should adopt the SA 8000 standards as a preventive measure.

Ethics of Advertising

How a company markets its products internationally will play a major role in whether it is successful. Failure to take into account the differences in national cultural and legal approaches to advertising is a recipe for failure. Internationally, the development of supranational rules of advertising has been sporadic. The best example of a multinational effort is the Marketing Supervision Network. The United States and about 20 other countries have agreed to cooperate in resolving advertising disputes that cross national boundaries.²⁹ At the regional level, the

European Union has enacted two directives aimed at harmonizing European law on misleading and **comparative advertising**.³⁰ Before the 1997 Directive 97/55/EC on Comparative Advertising was enacted, such advertising was banned in Italy, Belgium, and Luxembourg, and was highly restricted in such countries as Germany and France. In contrast, in the United States more than 25 percent of all advertising is comparative.³¹

The 1997 Directive legalizes the use of comparative advertising that is defined as “any advertising, which explicitly or by implication identifies a competitor or goods or services offered by a competitor.” However, comparative advertising is permitted only if: (1) it does not mislead; (2) it compares goods or services meeting the same needs or serving the same purpose; (3) it objectively compares one or more material, relevant, verifiable, and representative features of the goods and services; (4) it does not create confusion in the marketplace between the advertiser and a competitor or with the competitor’s trademarks or trade names; (5) it does not discredit or denigrate the trademarks, trade names, goods, or services of a competitor; (6) for products with designation of origin, it relates in each case to products with the same designation; and (7) it does not present goods or services as imitations or replicas of trademarked goods or services.

The EU Directive also requires that the advertiser demonstrate promptly the accuracy of its comparative claim. In contrast, the U.S. Federal Trade Commission only requires the proof of a *reasonable basis*. The use of subjective features such as taste or feel is permitted in the United States. Under the EU Directive’s requirement of objective proof, such comparative advertising is prohibited. “Comparison on the basis of subjective factors, and opinion-based puffery are therefore prohibited under the Directive. Furthermore, it seems that the adopted formula bans the use of objectively administered consumer preference tests.” Thus, the U.S. exporter should not assume that its comparative advertisements are automatically legal under the new Directive. This is especially true in countries that have traditionally prohibited such advertisements.

<p>Article 2: Decency Should not offend prevailing standards of decency.</p>	<p>knowledge. Testimonials that have become obsolete should not be used.</p>
<p>Article 3: Honesty Should not exploit consumers’ lack of experience or knowledge.</p>	<p>Article 10: Exploitation of Goodwill Should not infringe upon intellectual property or goodwill.</p>
<p>Article 4: Social Responsibility Should not condone any form of discrimination, play on fear, or play on superstition.</p>	<p>Article 11: Imitation Should not imitate other advertisements or unduly imitate others’ advertising campaigns in other countries.</p>
<p>Article 5: Truthful Presentation Should not mislead with regard to characteristics, value, terms of guarantee, intellectual property rights, or official recognition or approval and should not misuse research results.</p>	<p>Article 12: Identification Should not be made to appear as an editorial or news item. Should be presented so that it is readily recognized as an advertisement.</p>
<p>Article 6: Comparisons Comparison to other products should be based on facts that can be substantiated and should not be unfairly selected.</p>	<p>Article 14: Children Applies to children as defined as minors under applicable national laws. Should not exploit their inexperience or give unreal perception of the true value of the product. For example, the use of the word <i>only</i> should be avoided. Should not directly appeal to children to persuade their parents to buy the advertised products.</p>
<p>Article 7: Denigration Should not denigrate any firm, organization, profession, or product.</p>	<p>Article 15: Guarantees Should not contain any reference to a guarantee that does not provide the consumer with rights additional to those provided by law.</p>
<p>Article 8: Testimonials No use of personal testimonials or endorsements unless genuine, verifiable, relevant, and based upon personal experience or</p>	

Figure 2.10 *Doing Business Internationally*: ICC International Code of Advertising Practice.

Professional Standards of International Advertising

The ICC has sponsored a number of ethical codes relating to international advertising and marketing, including the International Code of Advertising Practice, International Code of Sales Promotion, International Code of Practice on Direct Marketing, Code on Environmental Advertising, Code on Sponsorship, and the ICC/ESOMAR International Code of Marketing and Social Research Practice. The ICC International Code of Advertising Practice (see Figure 2.10 *Doing Business Internationally*: “ICC International code of Advertising practice”) was first issued in 1937 and was revised in 1997. The ICC code applies to advertising in *any* medium for the sale of goods *or* services.

The introduction to the Code describes it as a voluntary, self-regulating ethical code but noted its use in a legal proceeding: “The Code is designed primarily as an instrument of self-discipline but it is also intended for the use of the courts as a reference document within the framework of applicable law.”³² The underlying principle of the Code is that “all advertising should be legal, decent, and truthful.” Articles 3 through 17 provide some details regarding the meaning of “decent and truthful.” Article 18 allots responsibilities to any professional advertising agency and any firm or company that advertises. Furthermore, anyone employed within these companies or agencies shall be liable to “a degree of responsibility commensurate with their positions.” This liability is levied against both the selling company and its advertising agency, along with responsible officers and employees.

Case Study

Choosing Values: Public–Private Relationships in a Global Economy³³

Definitions

Foreign Corrupt Practices Act (FCPA) is an American law that makes it illegal for American citizens, residents, companies, and foreign companies controlled by Americans to bribe foreign government officials.

Accounting Provision makes the failure to implement a reasonable accounting system likely to uncover the payment of bribes a violation of the FCPA. Therefore, someone may be convicted of violating the FCPA whether or not they bribed a foreign official.

Bribery is the giving of something of value in order to obtain or retain foreign government business. A bribe includes the giving of a payment, or promise to pay.

Exceptions to the FCPA include: (1) A routine government expenditure that allows payment of nominal bribes in exchange for a clerical act (processing of paperwork or issuing a permit). If the government official has discretion as to whether to process your request, then it is considered an inexcusable bribe under the FCPA. (2) A *bona fide* expenditure allows for the payment to a government official in exchange for additional services, such as police protection, electricity, and potable water supply. (3) Bribery is legal under the national laws of the foreign country (such a law does not exist); the fact that the giving

of a bribe is customary in a given culture is not sufficient to come within this exception.

Foreign Official is broadly defined as anyone related directly or indirectly to the government including political candidates and political parties.

Knowing Requirement requires the U.S. government to prove the American knowingly bribed the foreign official in order to impose a criminal punishment. Actual knowledge is not required; “reckless disregard” is sufficient.

Short Termism is the management practice of focusing on generating short-term profits to raise stock prices and increase executive compensation. Compare, “Sustainability.”

Sustainability may refer to different things like the sustainability of profits and environmental sustainability. The focus on the former is making decisions with the goal of creating profits in the long term. In the latter case is to mitigate environmental harm.

Third-Party Bribery provides liability to an American who hires agents that subsequently bribe a foreign official. Americans are required to perform due diligence in hiring third parties. This requires care when confronted with suspicious requests or “red flags,” such as not having a written agency contract; above market commission

rates; receiving substantially beneficial contracts from government; and commission payments made into foreign or secretive accounts.

Theory of Relative Development is a theory that poses that less developed countries and emerging economies should not be subject to the same (high) standards (health, safety, environmental standards) as developed countries. But these standards should be upgraded as a country reaches higher levels of development.

Introduction

The case study explores the scenario of foreign direct investment by an American company in a less-developed country. This development imbalance necessarily implicates issues of ethical relativism and host-home country standards. It provides five options to consider. The five options raise issues relating to corruption and the FCPA theory of relative development; business and ethical calculations; environmental ethics, sustainability, and the choice between short termism and long-term strategic decision-making.

Facts

TAPC (Trans-American Paper Company), an American paper manufacturer, has increased its operations outside of the United States, seeking sites that combined availability of wood and other biomass, abundant and clean water, and proximity to growing markets. One of its first foreign ventures was constructing a plant in Sabah, Malaysia. The paper manufacturing process requires large amounts of wood, electricity, and fresh water. The process produces toxic chemical waste, including solvents and chlorine to bleach and smooth pulp; biocides to prevent bacterial growth on this organic product; and carbon dioxide, nitrous oxides, sulphur dioxides, and airborne particulates, all of which pose environmental hazards to air and water.

TAPC located its plant in Sabah in 1989 due to the lower costs of labor, minimal regulatory controls, and management's anticipation of the growing demand for paper products in that area of the world. For several years the facility has been a source of concern. Plant management is aware of the growing pressure on the Malaysian government to better regulate air, ground, and water pollution; the Sabah plant is clearly deficient, especially in its inability to prevent water contamination. At present, however, such water pollution does not violate Malaysian law. TAPC purchases coal-fire-

produced electricity from the City of Sabah, which is now demanding an increase in the price of electricity, which will make TAPC substantially less competitive in the Asian market.

Problem

You are the head of TAPC's global strategy team that has been ordered to study the feasibility of different options and recommendations to be presented to the board of directors. The team discusses five options:

Option I: Replace Equipment But Don't Change Process

TAPC could retain its plant as is. The local plant manager, a Malaysian, recently met with a government official in Sabah who indicated that for a generous gift or facilitation fee he would be able to persuade the city to reduce its demand for price increases. When hearing about the FCPA, the official was willing to clear the way for a 10 percent discount on current electricity prices if TAPC made a substantial gift to a local charity.

Option II: Change Equipment to Become a Co-generation Plant

TAPC should make its own electricity by building a co-generation power plant on site that would produce extra output as well as generate additional revenues. In fact, officials from the local community, just "downstream" from Sabah, are willing to subsidize a portion of the cost of constructing the co-generation plant. In exchange, the community would receive a reliable supply of electricity for ten years at below market rates. The community also would pledge not to object to the plant's continuing emission of waste products, including the runoff from pulp production, chemicals and biological agents, and spent recycled sludge, into the river.

Option III: Build a New Plant in Malaysia Using All New Equipment

A Chinese venture capital firm (WIG) proposes to retrofit the existing plant with state-of-the-art paper manufacturing equipment. WIG would create a joint venture with TAPC in which WIG would have a 51 percent interest and TAPC a 49 percent interest. WIG possesses a patent on a technology to mix recycled sludge with concrete for non-weight bearing decorative cement applications and will

contribute all rights in the technology to the joint venture. WIG would have no difficulties in obtaining electricity from the City at highly favorable rates due to connections between the local construction company WIG would use in the construction of the new plant and the Malaysian government.

Option IV: Close the Plant

TAPC probably could sell the plant to WIG directly or find another buyer. Changes in government energy policy and the availability of new tax and investment incentives in the United States may make it feasible to increase production in the U.S.

Option V: Thinking Outside of the Box

Is there another option, or combination of options that the global strategy team has not considered that would provide a greater net benefit for TAPC and the other stakeholders?

Issues

- 1 Is there a proper balance between economic progress and environmental protection? How is that to be determined? Is it a zero-sum calculation? What time frame should be used in making such a calculation?
- 2 How does a company transact business in countries where there is a persistence of corruption and in which any profitable enterprise necessarily requires a high degree of public-private interaction?
- 3 Should the company consider distributive concerns premised on basic human rights and the profitability of the private company? For example, should the company consider the payment of higher-than-market-labor rates that reduces its overall profitability? Does paying a "living wage" necessarily result in lower corporate profits?
- 4 Does the company owe a higher degree of care to existing employees when considering relocation? Should the company consider the relative level of development when considering relocations between more fully developed and less-developed countries?

Problem

Which option would you recommend? In answering this question, use the approaches defined in the Ethics Toolkit and the 18 supplemental questions below! In considering the best option, the following themes should

be kept in mind: (1) the relationship between the key goal of directors and officers of companies to increase profitability, and that goal's relationship to other stakeholders of the company (employees, suppliers, creditors, local communities, environment); (2) importance of the difference between short termism (calculating the short-term impact of decisions relating to profitability and stock price) and long-term strategic growth (sustainability of profitability); (3) the relationship between alternative growth or profitability options and socially responsible courses of action; and (4) the potential trade-off between different means of production and their environmental impact.

Ethics Toolkit

(Ethical Schools of Thought)

Approach 1: Utilitarianism or teleology (consequentialism)

An action is right if the sum total of utilities produced is greater than that of an alternative act. A true utilitarian analysis takes the positive and negative production of utility for each stakeholder *directly* and *indirectly* affected by the decision. The utilitarian calculation changes given the term (time) when the utility is calculated. A short-term time frame may produce a lesser net welfare gain than a long-term time frame. A true utilitarian analysis seeks out alternatives that have a greater net welfare effect. *Option V* in the case study encourages the decision-maker to seek alternatives that further maximize benefits and lower costs.

Approach 2: Rights-Duties Approach (deontology or application of a priori principles)

A right is an individual entitlement to something that should not be interfered with by others including government authorities. Rights and duties are reciprocal in nature—for every right there is a correlative duty (vis-à-vis others). As compared to utilitarianism, a rights approach views morality from the perspective of the individual; often utilitarianism views ethical problems from the perspective of society as a whole. *Kantian Ethics* and its *Categorical Imperative* assert that the "rightness" of an act depends on its conformity to moral law. Kant's test of conformity was that of rational form. Moral laws must be *consistent* (they cannot be self-contradictory); *universal* (same for all persons; there is no such thing as relativism); and a *priori* (based on reason not experience).

Therefore, when contemplating an action, ask would you want it to become the basis for a universal law? Moral laws are premised upon respect for all rational beings. Humans may never be used as a means to an end. In the joint venture proposal by WIG, do all parties, including TAPC and the Malaysian governmental units, possess full knowledge of the nature of the agreement?

Approach 3: Justice and Fairness

There are numerous facets of justice including distributive, procedural, and corrective justice. Generally, justice concerns may result in a decision that a general net benefit to society (utilitarianism) cannot justify an injustice, such as discrimination upon a minority group. Alternatively, large social gains may justify a certain level of injustice (e. g., to combat extreme poverty). *Distributive justice* focuses upon how the burdens and benefits of an action are allocated among the different stakeholders. *Procedural justice* looks to the process of decision-making and the distributive impact of the decision. In John Rawls' *A Theory of Justice*, it is argued that fairness in the process satisfies justice concerns. Rawls' *difference principle* leverages the decision-making to recognize the social and economic inequalities and to make a decision that gives the greatest benefit to the least advantaged persons.

Approach 4: Ethics of Care

A narrow application of utilitarianism in case study would make the correct decision the one that produces the most net benefits to the company. The impact on existing or future employees would not be factored into such a narrow utility calculation. The ethics of care approach championed in Carol Gilligan's book, *In a Different Voice*, rejects such a narrow utility calculation for a broader stakeholder analysis. She challenges the utilitarian and Kantian views that all humans are to be treated the same (objectivity and impartiality). The ethics of care approach recognizes that certain *concrete* human relationships can and should be more highly weighted than other relationships in the utility calculation. Should TAPC more heavily weigh the care of its existing workers and communities than other stakeholders?

Supplemental Questions

- 1 Does a company have a duty to monitor the conduct of its partners, suppliers, and contractors (duty to monitor third parties)? Why?
- 2 Should a company commit itself not to harm the environment and to move toward sustainability (long-term sustainability versus short termism)?
- 3 What are the ethical and legal problems facing companies doing business in a global environment?
- 4 What are the ethical obligations of an American company doing business in a developing country?
- 5 Are there any "dominant considerations" or consequences (loss of life, violation of human rights, environmental destruction, breaking the law) that makes the utilitarian calculation less meaningful?
- 6 Under the *theory of relative development*, can a level of environmental pollution be justified in exchange for employment and raising a country's standard of living?
- 7 At what level of environmental harm should the tradeoff between pollution and economic benefits be terminated? Should the issue of "global warming" be factored into a decision relating to individual acts of pollution?
- 8 How would you prioritize net benefits (utilitarianism), rights (deontology or Kantian ethics), and justice (Rawls; distributive justice) concerns?
- 9 How can the ethics of care be used in business decision-making? What types of obligations does a corporation have toward the communities in which it works?
- 10 Does local determination of appropriate "gifts," as in the TAPC case, increase the chances of illegal and unethical bribery?
- 11 What facts or information would you want to know before making a decision to give a "gift" to a foreign charity suggested by a government official?
- 12 Is the gift or facilitation fee suggested in *Option I* of the case study a bribe under the FCPA?
- 13 Should possible past practices (bribery) be investigated? Why open a can of worms relating to past transgressions? How do the FCPA accounting provisions apply to this issue?
- 14 Do you see any issues in *Option II* where a local government in need of electricity offers not to complain about water pollution and other environmental harms caused by the TAPC's manufacturing plant in exchange for being able to buy the excess electricity produced by the co-generation plant? Does the theory of relative development impact this decision?
- 15 What would you like to see in the joint venture agreement with WIG (*Option III*) to safeguard against improper activities being conducted by

- | | |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>WIG? Should you be concerned that WIG will own 51 percent of the joint venture? Why?</p> <p>16 In <i>Option III</i>, what does the relationship with a local construction company have to do with receiving favorable rates from the government? What information or due diligence would you require?</p> | <p>17 What are the reasons that the TAPC should discourage human rights abuses and pay a fair wage?</p> <p>18 Is good business ethics good for business (profitability)?</p> |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

Chapter Summary

- Three common areas of ethical concern when doing business internationally include: (a) differences between host–home country standards, (b) bribery and corruption, and (c) sustainability and environmental ethics.
- Two views of international ethics are ethical relativism (culturally determined) and absolutism (universal ethical or moral principles).
- Schools of ethical thought include: (a) utilitarianism, (b) deontology (Kantian Ethics), (c) ethics of care, (d) virtue ethics, and (e) situation ethics. An integrative approach to ethics holds that if properly applied, the different schools of ethics should produce the same decision or outcome.
- There are two schools of thought regarding the role of companies in society: (a) the theory of the amoral businessperson that states that a company's only ethical obligation other than to make profits is to obey the law (moral minimum) and (b) corporate social responsibility that states companies are obligated to be good citizens by acting charitably and not harming the environment.
- The *Caux Round Table Principles for International Business* blend the Western concept of the dignity of all human beings with the Japanese concept of *kyosei*—that a primary value of society is working together for the common good.
- The Rio Declaration established world standards and goals for environment protection and sustainability.
- Penalties for criminal misconduct by an organization are set by using the U.S. Sentencing Guidelines for Organizations. Three factors mitigate against the severity of the penalties assessed: (a) effective compliance program, (b) self-reporting, and (c) cooperation in investigation.
- There is a trend in developing harmonized or international standards relating to goods, services, and employment. Some of the important international standards that have been developed are by the: (a) International Labor Organization, (b) International Organization for Standardization, and (c) the European Union with its CE Mark and Ecolabel.

Key Terms

Amendments of 1988 (FCPA)	Cultural Relativism	Foreign Corrupt Practices Act (FCPA)
Attorney General Opinion	Declaration on the Right to Development	Hedonism
Benefit–Cost Analysis	Distributive Justice	Incommensurability
Categorical Imperatives	Dominant Considerations	Integrative Ethics Approach
Caux Round Table Principles for International Business	Due Diligence	International Labour Organization
CE Mark	Ethical Relativism	International Organization for Standardization (ISO)
Charter of Fundamental Rights	Ethics of Care	ISO 9000
Comparative Advertising	EU Ecolabel	ISO 14000
Conflict of Cultural Traditions	Federal Sentencing Guidelines for Organizations	ISO 19600
Corporate Codes of Conduct		

ISO 26000	Organizational Ethics	Transparency International
Kantian Ethics	Rio Principles +	United Nations Declaration of
Moral Duty	Routine Government	Human Rights
Moral Minimum	Expenditures	Utilitarian Ethics
Moral Right	Social Accountability Standard	Virtue Ethics
Myth of the Amoral	Subordinate Responsibility	
Businessperson	Sustainable Development Goals	
Organisation for Economic	(SDGs)	
Co-Operation and Development	Theory of Relative Development	
(OECD)	Third-Party Bribery	

Chapter Problems

- 1 How can a parent company insulate itself from liability under the Foreign Corrupt Practices Act for acts of its foreign subsidiaries, affiliates, and partners? See Brown, "Parent-Subsidiary Liability Under the Foreign Corrupt Practices Act," 50 *Baylor Law Review* 1 (1998).
- 2 Devise a program for your company to ensure compliance with the Foreign Corrupt Practices Act. What is the importance of *corporate culture* to any such compliance program? See Goelzer, "Designing an FCPA Compliance Program: Minimizing the Risks of Improper Foreign Payments," 18 *Northwestern Journal of International Law & Business* 282 (1998). See also Head, "The Development of Compliance Programs: One Company's Experience," 18 *Northwestern Journal of International Law & Business* 535 (1998).
- 3 What is the difference between a bribe and a facilitation fee? Does it make a difference if payments or bribes are a crime in a foreign country, but such crimes are not enforced? If such payments are not considered illegal in a foreign country, is it proper to make such payments? From an ethical point of view, should the FCPA be read broadly or narrowly? Is giving a bribe a victimless crime? Does bribe-giving affect the free-market system? How? Do you believe that the FCPA places U.S. companies at a competitive disadvantage?
- 4 Your company has been trying for more than a year to obtain the assets of a formally government-owned petroleum business. However, the approval process and review of the contract documents have been held up for months in the government bureaucracy. An official approaches your Vice President of Acquisitions and suggests that if your company pays the expenses for a ten-day "negotiating" trip for himself and his family to Disney World and Miami, the approval process could be completed within one week. Should your company authorize the expenditure? Would your answer be different if it were a \$200 "fee" to expedite the importation of your company's products into the country?
- 5 You have obtained a U.S. government grant to help train physicians in a developing country on new techniques for fighting AIDS. While working within the developing country's Ministry of Disease Control you have uncovered evidence that certain monies received through the International Red Cross had been misappropriated by certain officials in the Ministry. The money was to be used to test and ensure the safety of the country's blood supply. Instead, it seems that the money was used to buy new ambulances for some of the country's hospitals. Should you report this transgression? Do you have any legal duty to report? Do you have an ethical duty to report? If so, to whom? Does the fact that such reporting may jeopardize your relationship with members of the Ministry and the U.S. agency that hired you enter into your decision? Does the FCPA apply to this case? How can materials on "whistleblowing" be applied to this hypothetical? Do you have an obligation to obtain a sufficient amount of evidence before reporting?
- 6 Your company transfers you to a foreign subsidiary as an assistant manager of operations. The purpose

of the assignment is to be trained by one of the company's "top managers." Soon after arriving you discover that the manager had instituted an unusual accounting system. You have no real evidence, but the talk around the office is that the manager's success is due to his payments to his government connections. It is also rumored that some of the hidden transactions have profited the manager personally. The subsidiary remains one of the most profitable of your company's foreign operations. What do you do?

- 7 Lord Coke had this to say about bribery: "Though the bribe be small, yet the fault is great." Do you agree that the size of the bribe is unimportant in determining legal or ethical wrongdoing?
- 8 What are the elements of an effective ethics or environmental compliance program? How would you develop an ethics or environmental compliance program that would satisfy the dictates of the Federal Sentencing Guidelines for Organizations? See Paul Fiorelli, "Fine Reductions through Effective Ethics Programs," 56 *Albany Law Review* 403 (1992); Paul Fiorelli, "The Environmental Sentencing Guidelines for Business Organizations," 22 *Boston College Environmental Affairs Law Review* 481 (1995).
- 9 It is currently estimated that only 13 percent of middle managers posted overseas by U.S. companies are women, even though women make up nearly half of the middle managers at these companies. What do you think are the reasons for such an imbalance? At the same time, a poll of human resources executives shows that 80 percent of them believed that global work experience was essential for advancement. Can this be seen as the potential for creating a global glass ceiling? What can companies do to overcome such bias?
- 10 In 1971, John Rawls published his masterwork, *A Theory of Justice*. Simply stated, he equated justice with notions of procedural fairness. Rawlsian justice judges a decision or rule on whether it was arrived at through a process of procedural fairness. Thus, a decision is just or ethical if it was fairly made. A decision or rule is fairly made if each person affected by it is given the most extensive basic liberties compatible with the similar rights of others. Furthermore, social and economic inequalities are arranged to the greatest benefit of the least advantaged persons, and such inequalities are attached to positions open to all under conditions of fair equality of opportunity. Although Rawls' approach is targeted at political and not moral theory, its use in dealing with the least advantaged countries of the world may be productive. These rules are to be applied behind a *veil of ignorance* where the parties are unaware of their status or positions. How can this approach be used to ethically judge dealings between developed and developing countries? If these rules were applied behind such a veil, then would such dealings likely result in more equitable transactions?
- 11 One of the negative by-products of the corporate ethics movement is a decrease in employee privacy. In order to ensure ethical compliance in the workplace, employers will feel pressure to monitor employee activities. To discourage employee misbehavior, employers have begun to monitor employee use of the company's e-mail system to discourage its use for personal purposes and as a vehicle of sexual harassment. Some companies have installed video cameras to monitor employee movements. How should companies balance their ethics monitoring with employee privacy concerns? Need they fully disclose to their employees the extent of their monitoring practices?
- 12 Define and give an example of each of the following concepts:
 - 1 Ethical Relativism
 - 2 Distributive Justice
 - 3 Dominant Consideration
 - 4 Ethics of Care
 - 5 Problem of Subordinate Responsibility
 - 6 Theory of Relative Development
 - 7 Routine Government Expenditure
 - 8 Bona Fide Expenditure
 - 9 Third-Party Bribery
 - 10 Anti-Corruption Clause

Business Ethics Quiz

- 1 You are an office manager, and one upper-level manager has repeatedly used the company credit card for personal expenses. How do you handle the situation?
 - a You do nothing because the person is higher up in the organization.
 - b You confront the person and hope that it will not affect your job.

- c You confront the person and report your finding to a higher-level manager in human resources.
- 2 You are a middle-level manager with no accounting experience, and a new company policy requires you to sign the balance sheet and tax information for your department. What do you do?
 - a You sign it because it is required and you are not expected to know whether it is accurate.
 - b You ask someone more knowledgeable to review the material with you.
 - c You sign it with the hope of taking an accounting course for future purposes.
- 3 You are on the hiring committee for a key position at your company. A woman interviews for the job and, although you do not ask, it comes out that she wants to start a family. Can you factor in that there is a likelihood she may leave or take a maternity leave in the near future?
 - a Yes, you can factor the information into the hiring decision because she volunteered the information.
 - b No, it is discrimination if you do not hire her based on that information.
- c If another candidate has the same record, you can use the information to “break the tie.”
- 4 You have been asked to work with the publications team on a press release for a new product that you worked to develop. However, the product did not turn out as well as promised in earlier press releases. How much do you reveal in the press release?
 - a You do not reveal the new information, in order to protect the image of your company.
 - b You write a more mildly enthusiastic, but honest, press release.
 - c You write a brutally honest press release thinking it will earn the respect of your customers.
- 5 You are in charge of preparing a budget report for a project that will be presented to the board of directors. Just before the board meeting, the president of the company asks you to leave something negative out of the report and just add it to the next report as a favor. What do you do?
 - a Yes, since holding the information to the next meeting shouldn’t do any harm.
 - b Yes, but only if the president agrees to return the favor in your year-end bonus.
 - c No, because one exception to the rule may lead to future exceptions.

Internet Exercises

- 1 Review the Corruption Perception Index published by Transparency International at <http://www.transparency.org>.
- 2 Review the web site of *Sweatshop Watch* for recent developments involving the problem of low labor standards in the international production of goods: <http://www.sweatshopwatch.org>.

Other Internet Sources

Markkula Center for Applied Ethics: www.scu.edu/ethics (database of nearly one thousand links on ethics including business and environmental ethics); see also, **Poe Ethics Center at the University of Florida:** <http://warrington.ufl.edu/centers/poe>.

Caux Round Table: www.cauxroundtable.org (social corporate responsibility).

International Society for Environmental Ethics at <http://www.cep.unt.edu/ISEE.html>.

Transparency International: <http://www.transparency.org>.

OECD Convention on Combating Bribery of Foreign Public Officials:

<http://www.oecd.org/corruption/oecdantibriberyconvention.htm>.

U.S. Sentencing Commission: <http://www.ussc.gov/guidelines-manual/2014/2014-chapter-8> (Organizational Guidelines and Compliance).

Answers to Business Ethics Quiz

Question 1: (c) Need to report to upper-level officer in human resources to make sure the improper conduct won't continue.

Question 2: (b) Ask someone with expertise to review the financial and accounting materials.

Question 3: (b) Deciding not to hire an applicant because she or he is planning on starting a family is illegal discrimination.

Question 4: (b) It is reasonable to expect that a press release will put a positive spin on the subject of the release. An optimistic press release that is honest should be sufficient, unless the withholding of the information would have major negative consequences.

Question 5: (c) Withholding information from the board of directors is a form of misrepresentation. This may lead to the development of a bad habit, which is a slippery slope toward white-collar crime.

Notes

- 1 United Nations General Assembly Resolution 41/128 (December 16, 1986).
- 2 Thomas Donaldson, "Values in Tension: Ethics Away from Home," *Harvard Business Review* (September–October 1996).
- 3 Carol Gilligan, *In a Different Voice: Psychology Theory and Women's Development* (1982).
- 4 See R. Moorthy, Richard DeGeorge, Thomas Donaldson, William Ellos, Robert Solomon, and Robert Textor, *Uncompromising Integrity: Motorola's Global Challenge* (1998).
- 5 Milton Friedman, "The Social Responsibility of Business Is to Increase Profits," *New York Times Magazine* (1970).
- 6 Francis Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (1995).
- 7 Hong Sik Cho, "An Overview of Korean Environmental Law," 29 *Environmental Law* 501 (1999).
- 8 A/RES/66/288.
- 9 Transparency International, *Annual Report 2010* 84 (Alice Harrison and Michael Sidwell eds., 2011), available at http://archive.transparency.org/publications/annual_report.
- 10 See <http://www.transparency.org/cpi2014/results>.
- 11 The number in parentheses is the score on the Corruption Index, with 100 being no corruption at all.
- 12 Nicholas Lord, *Regulating Corporate Bribery in International Business* 19 (2014).
- 13 M. Cecilia Arruda, "Business Ethics in Latin America," 16 *Journal of Business Ethics* 1597 (1997).
- 14 Amended in 1988 in 15 U.S.C. § 78.
- 15 Lawrence Trautman and Kara Altenbaumer-Price, "Foreign Corrupt Practices Act: An Update on Enforcement and SEC and DOJ Guidance," *Securities Reg. L.J.* 241, 251–252 (2013).
- 16 915 F.2d 1024 (6th Cir. 1990).
- 17 2 FCPA Rep. (1980).
- 18 Lawrence Trautman and Kara Altenbaumer-Price, "Lawyers, Guns, and Money: The Bribery Problem and the UK Bribery Act," 47 *The International Lawyer* 482 (2013).
- 19 *Ibid* at 504–505.
- 20 *Ibid*.
- 21 Paula Desio, "An Overview of the Organizational Guidelines," United States Sentencing Commission at <http://www.uscc.gov/guidelines-manual/guidelines-manual>.
- 22 "High-level personnel of the organization" means an individual who has substantial control over the organization or who has a substantial role in the making of policy within the organization. The term includes: a director; an executive officer; an individual in charge of a major business or functional unit of the organization, such as sales, administration, or finance; and an individual with a substantial ownership interest.
- 23 United States Sentencing Commission, Case No. 88-266, as discussed in Lynn Sharpe Paine, "Managing for Organizational Integrity," *Harvard Business Review* 110 (March–April 1994).
- 24 The general statutory provisions governing a sentence of a fine are set forth in 18 U.S.C. § 3571.
- 25 O. C. Ferrell, Debbie Thorne LeClair, and Linda Ferrell, "The Federal Sentencing Guidelines for Organizations: A Framework for Ethical Compliance," 17 *Journal of Business Ethics* 353–354 (1998).
- 26 *In re Union Carbide Corp. (Gas Plant Disaster at Bhopal)*, 809 F.2d 195 (1987).
- 27 ICC, *Anti-Corruption Clause* (2012) (ICC Publication No. 740E).
- 28 See Jennifer Sawayda, "Introduction to ISO," University of Mexico's Daniel Ethics Initiative at <http://e-businessethics.com>.

LEGAL ENVIRONMENT

- 29 Allyson L. Stewart, "International Marketing Police Resolve Trading Disputes," *Marketing News* 15 (June 7, 1993).
- 30 Directive 84/450/EEC (1984) ("Misleading Advertising Directive").
- 31 Paul Spink and Ross Petty, "Comparative Advertising in the European Union," 47 *International & Comparative Law Quarterly* 855 (1998).
- 32 ICC, *International Code of Advertising Practice*, Introduction (1997 edition).
- 33 For longer version of case study, see Larry A. DiMatteo and Virginia G. Maurer, "Choosing Values: Public-Private Relationships in a Global Economy," 32 *Journal of Legal Studies Education* 313 (2015).

STRATEGIES FOR INTERNATIONAL BUSINESS

A U.S. company must develop a strategy or business plan when deciding to establish a foreign business operation. A foreign business strategy encompasses activities like hiring foreign employees, establishing a foreign office, and acquiring foreign business assets, including the acquisition of companies or the incorporation of a subsidiary. The factors that affect planning foreign operations, like the risks of international business transactions, vary depending on the country, type of industry, size of operation, and legal issues such as foreign regulations and taxation.

As discussed in Chapter 1, the first major decision is whether entry into a foreign country should be through a direct or indirect presence. The most indirect form of foreign entry is through exportation of goods or the licensing of technology. These transactions can involve little direct contact or the use of surrogates or agents within the country. A company that wants to do more than just sell to a foreign importer but that does not want a direct presence within a country will often hire agents or independent contractors to help market, sell, and distribute its products. These agents are generally hired as independent contractors and not as direct employees.

Strategies for Doing Business

Foreign countries offer equivalent forms of doing business as are found in the U.S. The establishment of a business organization is done under state laws in the U.S., while in most foreign countries, federal, or national law regulate the establishment of businesses, as well as registration with various levels of government including at the local level. The entities reviewed in this area include: the branch office, partnerships and joint ventures, limited liability companies, and corporations.

The least costly way of starting a business in a foreign country is through a **branch office**. Generally, the only formal procedure required to establish a branch is to register to do business with the appropriate state regulatory agency. The branch is considered simply **an extension of the foreign corporation**, and the corporation remains liable for the debts of the branch office.

Alternatively, the foreign corporation may elect to operate one of a number of independent entities, including the joint venture, general partnership, limited partnership, corporation, and limited liability companies. The **joint venture** is **a hybrid that forms either a partnership or a corporation**. A joint venture can be loosely defined as an association between two or more parties with an agreement to share the profits and often the management of a particular project. In the United States, the joint venture is commonly treated as a partnership, especially for tax purposes. The joint venture is a common method for international business investment, in which a foreign company seeks out a domestic company in order to penetrate the host country's market. The advantages of joint venturing will be discussed in greater detail later in the chapter.

In a **general partnership**, all the **partners are jointly and severally liable for partnership debts**. Unlike in a joint venture, a partnership mandate is more flexible and ongoing. Where a joint venture is established to accomplish a narrow business objective, a general partnership generally envisions a long-term evolution of the business, including the development of goals not contemplated by the partners at the time of inception. In a partnership, as in the partnership-style joint venture, the losses and profits of the business *pass through* directly to the partners for purposes of taxation. This avoids the problem of double taxation most closely associated with the corporation.

The **limited partnership** couples the pass-through feature of a general partnership with the concept of limited liability found in a corporation. Limited liability is achieved through the division of the partners into two classes: general and limited partners. The general partner has unlimited liability, while the **limited partners are liable only up to the amount of their capital contributions**. A limited partnership, however, is a statutorily created mode of doing business. Unlike the general partnership, which originates in common law, the limited partnership must fulfill a state's limited partnership statute requirements. In contrast, the general partnership is formed simply through the agreement, express or implied, of the partners. The benefit of limited liability comes at a price; state law requires that a **limited partner be a silent or passive investor**. A limited partner who becomes involved in the day-to-day management of the business acquires the status of a general partner and, as a general partner, will possess unlimited liability for the debts of the partnership.

The most dominant form of entity in the U.S. has become the **limited liability company (LLC)**. The LLC is one of a new generation of limited liability entities that include the limited liability partnership (LLP) and the professional association (PA). Types of limited liability companies vary by state law, but all states have the LLC.

The greatest advantage of LLCs is that they provide limited liability without the formalism of the corporation. In some instances, an LLC may be an alternative to a joint venture or limited partnership, offering both the flexibility of a partnership and the limited liability of the corporation. The LLC is controlled by an "operating agreement," but unlike the corporation, there are no requirements or restrictions on its contents. Therefore, the protections developed in corporation law to protect minority shareholders do not apply to members of a LLC.

A newer form of business that has become popular is the **social enterprise company** or beneficial corporation. Such entities apply commercial strategies to maximize improvements in human and environmental well-being, as well as making profits for its owners. Making money for shareholders is considered secondary to maximizing social impact. Social enterprises can be structured as for-profit or not-for-profit businesses, and may take different forms depending on the country where it is established, such as a cooperative, benefits corporation, or charitable organization. Many corporations take their social responsibilities seriously and invest company money in charitable causes, while the social enterprise company's charitable commitment is central to the mission of the business. In the U.S., a **benefit corporation** or B-corporation is a type of for-profit corporate entity, legislated in a majority of American states, that includes positive impact on society and the environment in addition to profit-making as its legally defined goals. These forms of doing business are part of a general movement or trend toward **social entrepreneurship**, which in many cases are international in nature. See Figure 3.1 *Doing Business Internationally: "Case of Grameen Bank, Microfinancing, and Crowdfunding."*

The most common form of doing business for the foreign investor is the **corporation**, where an investor purchases shares in an existing or newly formed corporation. As a shareholder, the investor's liability is generally limited to the amount paid for the shares of stock. The corporation is created when the shareholders file a *certificate of incorporation* with one of the 50 Secretaries of State. In the past, Delaware was the most popular state of incorporation because of its liberal corporate laws. Today, most states have simplified their laws to make it easier for corporations to conduct business. Once incorporated, a business is required to file annual reports or pay state franchise taxes. Most states do not differentiate between corporations owned by residents or by foreign nationals. Once a corporation receives its charter from the state, other parties are prohibited from using its corporate name when doing business in that state.

Strategies for Entering a Foreign Market

A U.S. company that wants a direct foreign presence has a number of options, including establishing a representative office, a joint venture with an established company, setting up a branch office, or forming a full-scale foreign subsidiary. Forming a foreign subsidiary requires deeper business and legal involvement than establishing a representative office. A **representative office** is established for limited purposes, such as undertaking market analysis and product promotion. Host country laws dictate what types of activities a representative office may pursue. For example, a representative office may **obtain leads of potential customers** but cannot negotiate or enter into contracts, tasks reserved to the parent company in the home country. The advantage of operating a

One of the more famous early examples of social entrepreneurship was Grameen Bank. Commercial or investment banks are one of the types of generators of economic wealth. What makes Grameen bank different is that it pioneered the concept of *microcredit* for supporting small or startup businesses in multiple developing or improvised countries in Asia, Africa, and Latin America. It provides loans to impoverished persons or businesses that do not qualify for mainstream loans generally due to lack of a credit or employment history, assets, or collateral. These high-risk loans have proved not to be that risky after all. Grameen Bank reported that repayment rates were a stunning 98 percent. Bangladeshi social entrepreneur Muhammad Yunus, the founder of Grameen Bank, was recognized with the Nobel Peace Prize in 2006, as well as the United States' Presidential Medal of Freedom in 2009 and the Congressional Gold Medal in 2010. The United Nations declared 2005 as the International Year of Microcredit.

Microcredit is now part of the microfinance movement that supports entrepreneurship with the ultimate purpose of alleviating poverty, as well as empowering women and raising the standard of living for entire communities. Microfinance includes providing loans, but also provides a wider range of financial services, such as establishing savings for the poor. In many communities, women lack the highly stable employment histories that traditional lenders tend to require. Many are illiterate and therefore unable to complete paperwork required to get conventional loans. It is estimated that as of 2009 an estimated 74 million men and women held microloans that totaled US\$38 billion.¹

Real World Stories from the Grameen Foundation²

Microlending. A poor Indonesian couple barely survives by running a food stand in front of their home. They attended a microloan informational meeting and subsequently obtained a \$100 loan that they used to purchase more materials and equipment, allowing them to produce more food in a shorter period of time. Their daily profits soon increased by 33 percent. Their dream is to someday own their own restaurant.

Microsavings Accounts. An aunt and her niece in the Philippines save for their children's future. "Every day, a savings officer visits their home and collects about 50 cents from Elsa and other members of her savings group. On good days, Elsa deposits even more money. Her goal is to save about \$200 so that she will be ready when tuition fees are due for her children."

An even newer source for raising funds is **crowdfunding**. Crowdfunding usually entails a person or entity who proposes a project to be funded, individuals or groups who support the idea, and a moderating organization or platform that acts as conduit between the parties. Crowdfunding is actually an old idea. For example, government funding could not be found for building the giant pedestal upon which stands the Statue of Liberty. In 1885, successful fundraising resulted in donations by more than 120,000 contributors. Crowdfunding was used again in the 1980s to finance the restoration of the Statue. The Internet has made crowdfunding easier, with an estimated \$5.3 billion raised in 2013. Despite its growth and promise, it has proven a difficult fundraising model in emerging markets. In China, funding parties fear online scamming, the lack of trusted intermediaries, lack of transparency, and weak intellectual property law enforcement has slowed the growth of crowdfunding.

Figure 3.1 Doing Business Internationally: Case of Grameen Bank, Microfinancing, and Crowdfunding.

representative office is that the company is not considered to be *doing business* in the foreign country, so it will avoid host country regulations and will not be subject to foreign taxation. Such offices are relatively inexpensive and the easiest to establish.

In order to have a full-time presence and to transact business, a company will need to establish an operation to do business within a foreign country. The joint venture vehicle allows a company to share expertise and risks with a local partner, who often brings benefits such as customer and distribution networks, existing contacts with important government officers, and knowledge of the host country's legal and regulatory system. A joint venture may also be the only option in a country that prohibits wholly owned foreign subsidiaries. A joint venture is usually a partnership, but can also be undertaken by establishing a corporation or **limited liability company with each party owning a portion of the equity**. These types of enterprises are referred to as **equity joint ventures**. A third option, where the parties agree to perform certain tasks without forming a new entity, is a **contractual joint venture**. Factors like taxation, liability, and host country commercial and corporate laws, however, will influence the form of the joint venture. The parties to a joint venture will need to research whether the joint venture can be formed under U.S. law, the law of the host country, or the laws of a third country, and which will be the most favorable.

Another means of entering a foreign market is the **foreign subsidiary** or **affiliate**. A company may elect to establish an independent foreign subsidiary or an affiliate. An **affiliate** is **a business enterprise located in one country that is directly or indirectly owned or controlled by a company located in another country**. Ownership of 10 percent of its voting securities is generally considered "control." The subsidiary is generally established under the laws of the foreign country and pays taxes on the profits it earns in the foreign country, but the parent company's income will not be subject to host country taxation. Companies with foreign subsidiaries often attempt to reduce the



Image 3.1 Strategy.

enterprise's overall tax liability through **transfer pricing**, where one subsidiary of an enterprise charges another for goods or services. Companies manipulate these transfer prices in order to move profits to countries with lower tax rates. Foreign subsidiaries may be heavily regulated in some countries. For example, some host countries require that a portion of the subsidiary be locally owned and that the board of directors include nationals of the host country. In some countries the establishment of a wholly owned foreign subsidiary may not be possible. Also, foreign corporation laws may not be as friendly as U.S. law in limiting the liability of the parent company. In certain countries, a creditor is allowed to pierce the corporate veil more easily to sue the parent company. The crucial advantages of a foreign subsidiary over the branch office are that the parent company has limited liability and is able to carry on a broad range of business activities.

No matter what type of enterprise is selected, joint venture or foreign subsidiary, a company can be required to submit to a vigorous approval process. Upon authorization, the foreign enterprise is issued a business license to conduct business. In China, the use of a Chinese consultant familiar with the approval process and having *quanxi* (connections) with central and local government authorities is essential. For more on investing in China, see Chapter 9, "Emerging Economies: China."

Foreign Corporation Law

The roles and duties played by different constituent groups, such as the shareholders and board of directors, vary under foreign corporate laws (see Figure 3.2 *Comparative Law*: "Corporate Governance in the United States, Germany, and Japan"). Japanese corporate law is strikingly similar to U.S. corporate law: The shareholders elect the board of directors, and the directors owe the traditional duties of loyalty and care to the corporation and its shareholders. Securities laws in Japan, however, do not play the central role that they play in the United States. Bank financing, not security offerings, remain the fundamental vehicle for financing corporate expansion in Japan. Because corporate capital is largely privately funded, the need for disclosure, as mandated under U.S. securities laws, is not as important in Japan as it is in the United States.

In contrast, the corporate laws of Germany, China, and France reflect fundamentally different views of the objectives of the board of directors and the role of the corporation in society. Germany mandates a two-tiered board of directors: the supervisory board and the management board. The employees and the shareholders each elect one-half of the **supervisory board**, which then appoints the management board members. The supervisory board oversees the **management board** and approves the financial statements and major corporate decisions.

Corporate Goals and Objectives

What differentiates the governance structures of the U.S., Japan, and Germany are the roles the various stakeholders play in monitoring and controlling the firm. For example, in the United States, the primary stakeholder has been the shareholder, whereas in Japan and Germany, labor historically also has had a relatively strong voice. The American Law Institute asserts that a corporation's primary objective should be "corporate profit and shareholder gain." Traditionally, Japanese corporations have operated to benefit a small group of owners, rather than to maximize shareholder value. Its corporate governance system emphasizes the protection of employees and creditor interests as much or more than shareholder interests. Management has few direct incentives to enhance shareholder value. German law clearly defines the goals of German corporations. Its business corporation statute states that: "the managing board, on its own responsibility, is to manage the corporation for the good of the enterprise and its employees, the common weal of society, and the State." German law dictates that managers operate the firm for the benefit of multiple stakeholders, not just shareholders.

Management Structure

In the United States, shareholders typically elect directors at annual shareholder meetings. Labor is rarely involved in the

corporate governance system. Japan, like the U.S., uses a single-tier board structure. Traditionally, Japanese boards have been large, with some of the largest firms having more than 50 directors. Most typically, board members will be current or former senior and middle management. The mixing of management and director roles in Japanese corporate governance is in stark contrast to the separate, independent roles encouraged in U.S. corporate governance law. The system used in Germany is significantly different from those in either the United States or Japan. In large German firms, employees select half the board of directors. This practice is known as *co-determination*. Modern German corporations with over 500 employees have a two-tiered board structure. A supervisory board performs the strategic oversight role, while a management board performs the operational and day-to-day management role. In firms with over 2,000 employees, employees must comprise half of the supervisory board; shareholder representatives make up the other half. Supervisory boards also may include representatives of firms with whom the corporation has vertical relationships, such as suppliers and customers. The supervisory board appoints and oversees the management board. The German board structure thus functions to explicitly represent the interests of non-shareholder constituents and ensures that major strategic decisions are not made without the consent of employees and their representatives.

Figure 3.2 Comparative Law: Corporate Governance in the United States, Germany, and Japan.³

The management board carries out the strategic objectives established by the supervisory board and makes the day-to-day decisions in managing the company. The German corporate structure places a primary emphasis on the interests of the employees and a secondary emphasis on shareholder interests.

In China, approval of the shareholders is the dominant form of corporate decision-making. Unlike in the United States, shareholder power pervades the day-to-day operation of the company. The Chinese Company Law requires large companies to establish a supervisory committee of shareholders, which has the power to investigate and supervise the financial affairs of the company. Furthermore, shareholders are authorized to pass their own resolutions that must be implemented by the board of directors. Business plans and investment decisions are formulated by the board of directors, but must be submitted to the shareholders for approval.

French corporate law is unique because it provides alternate governance structures for the public corporation, or *S.A.* The articles of incorporation may select a management structure that is headed by a U.S.-style board of directors or one that consists of a management committee or executive board and a **shareholders' council**. The latter form acts in many ways like the two-tiered system found in Germany. The shareholders' council possesses most of the powers that are delegated to the board of directors under U.S. corporate law.

Piercing the Corporate Veil

United States corporate law and practice is considered to be corporation friendly. The limitation on personal liability offered by the corporate form is highly guarded by U.S. courts. The formation of a corporation with minimal capitalization is sufficient to shield the corporate shareholders from personal liability for the debts and obligations of the corporation. This protection is given whether the shareholder is an individual or a parent corporation. Thus, a corporation may use an independent incorporated subsidiary to shield itself from liability. However, U.S. law does allow a court to disregard the corporate form through the doctrine of **piercing the corporate veil**. If the corporate form is considered a sham, U.S. courts may allow the shareholders to be sued personally for the debts of the disregarded corporation.

The case of *Raven Metal Products v. McGann*⁴ illustrates some of the factors a court assesses when deciding if a corporate entity should be disregarded and the entity's owners exposed to personal liability. Raven Metal brought suit for breach of contract for nonpayment for materials delivered to Northeast Trailer, Inc. Brenda McGann was the sole director, officer, and shareholder of Northeast Trailer. Northeast held no corporate meetings, and no corporate records existed. McGann used corporate funds to pay personal expenses. The court stated that there are two general elements that must be met in order to pierce the corporate veil. First, **the owners must exercise complete domination of the corporation in respect to the transaction being attacked.** Second, **such domination is used to commit a fraud or wrong against the plaintiff.** The court refused to pierce the corporate veil because there was no wrongful act, and despite the domination of McGann over Northeast, there was no evidence of actual fraud. Furthermore, the court noted that the corporate money used to pay personal expenses was not in excess of what McGann's services were worth to the corporation. This case illustrates the U.S. view in favor of upholding the limited liability of the corporate form.

The *Finnish Fur Sales v. Shulof* case below shows that the U.S. presumption against piercing the corporate veil is not held as strongly in other countries. The case also introduces the bill of exchange instrument and the law of negotiable instruments as separate vehicles of liability. This area of law will be more fully explored in Chapter 15, "International Trade Finance."

Finnish Fur Sales Co., Ltd. v. Juliette Shulof

770 F. Supp. 139 (S.D.N.Y. 1991)

Leisure, District Judge. This is an action to collect sums allegedly owed in connection with furs purchased at two auctions in Vantaa, Finland. Plaintiff Finnish Fur Sales Co., Ltd. ("FFS"), asserts its claim of failure to pay for and clear 2,469 fox pelts against defendants Juliette Shulof Furs, Inc. ("JSF"), and George Shulof. Plaintiff Okobank Osuuspankkien Keskuspankki Oy ("Okobank") asserts its claim of failure to honor a bill of exchange against defendants JSF and Juliette Shulof. FFS is a limited company organized under Finnish law, which sells fur pelts raised by Finnish breeders at public auctions held several times each year. The auctions are conducted under certain Conditions of Sale ("Conditions"), which are listed in the auction catalogue, a copy of which is given to each prospective bidder in advance of the auction. A one-page English translation of the Conditions appears on the inside cover of the catalogue.

JSF is a New York corporation that has conducted a fur business for approximately 15 years. George Shulof, an officer of JSF, has been in the fur business since 1935. Mr. Shulof attended the FFS auctions held in Vantaa, Finland, in January and May 1987. He purchased over \$500,000 worth of skins at the January auction, and some \$700,000 worth of skins at the May auction. FFS claims that, in addition to the liability of JSF, Mr. Shulof is personally liable for this debt, based on Finnish law, the custom and practice of the fur trade, and the provisions of section 4 of the Conditions. Section 4 provides: "Any

person bidding at the auction shall stand surety as for his own debt until full payment is made for purchased merchandise." George Shulof denies any personal liability on the grounds, *inter alia*, that the provision is unenforceable under both New York and Finnish law. JSF made a cash down payment and accepted a bill of exchange (the "Bill of Exchange") for \$30,328.39. According to plaintiffs, in January 1989, Okobank became holder in due course of the bill of exchange, which was presented for collection on or about February 7, 1989, at Bank Leumi in New York, but was dishonored. The bill of exchange was signed "Juliette A. Shulof" above the printed name "Juliette Shulof Furs Inc."

Liability of George Shulof

In this case, application of New York choice of law analysis is required. Section 15 of the Conditions provides that "these conditions are governed by Finnish law." The courts of this Circuit routinely enforce the choice of law clause "if there is a reasonable basis for the choice." Finland's contacts with the transactions at issue are substantial, rendering the choice of law clause enforceable unless a strong public policy of New York is impaired by the application of Finnish law. Mr. Shulof argues that, under New York law, Section 4 of the Conditions would be invalid as contravening New York's policy against imposing personal liability on corporate officers.

It is also well established under New York law, as under Finnish law, that “the owner of property offered for sale at auction has the right to prescribe the manner, conditions and terms of sale. The conditions of a public sale, announced by the auctioneer at the time and place of the sale, are binding on the purchaser, whether or not he knew or heard them.” In the case at bar, George Shulof contends that the provisions of Section 4 are unconscionable and would not be enforced by a New York court. Nevertheless, a perusal of the Conditions reveals that their entire text is only a single page long, and that all of the Conditions, including Section 4, are printed in the same size print, which, although small, is legible. Under these circumstances, it seems unlikely that a New York court would refuse to enforce Section 4 in an arm’s-length commercial transaction involving a sophisticated defendant accustomed to bidding at fur auctions.

Given the lack of a clear conflict with either New York law or policy, this Court concludes that a New York court would apply Finnish law to the issue before the Court. The Court also notes that a similar result has often been reached under New York conflicts rules even in the absence of a contractual choice of law clause. Thus, Mr. Shulof must be held jointly and severally liable with JSF for any damages owed to FFS for the furs purchased at its 1987 auctions.

Liability of Juliette Shulof

The parties agree that New York law governs the issue of the liability of Juliette Shulof on the bill of exchange, which was executed and payable in New York. The parties do not dispute that the Bill of Exchange is a negotiable instrument, and therefore subject to the provisions of Article 3 of the Uniform Commercial Code, as adopted by the state of New York. The relevant section of the Code is § 3-403, which governs signatures by authorized representatives. Under subsection (2), An authorized representative who signs his own name to an instrument:

- a *is personally obligated if the instrument neither names the person represented nor shows that the representative signed in a representative capacity;*
- b *except as otherwise established between the immediate parties, is personally obligated if the instrument names the person represented but does not show that the representative signed in a representative capacity, or if the instrument does not name the person represented but does show that the representative signed in a representative capacity.*

An Official Comment to this section offers examples of signatures and the legal implication of each type of signature. An authorized representative will not be personally

bound by the following: a signature in the name of the represented party; “Peter Pringle by Arthur Adams, Agent”; or “Arthur Adams, Agent” (assuming that the principal is named in the instrument). In the case of a signature such as “Arthur Adams, Agent,” or “Peter Pringle Arthur Adams,” parol evidence may be offered in litigation between the immediate parties to prove representative capacity.

In the case at bar, Mrs. Shulof signed as “Juliette A. Shulof” above a typed name of “Juliette Shulof Furs Inc.,” which had been typed in by the preparer of the instrument, FFS. The cases interpreting signatures of this type demonstrate the special treatment of negotiable instruments under New York law. As reflected in the discussion in an earlier section of this opinion, New York has, as a general rule, a policy against imposing personal liability on corporate officers if the circumstances are ambiguous. However, this policy gives way before the policy considerations underlying N.Y.U.C.C. § 3-403, which “aims to foster certainty and definiteness in the law of commercial paper, requirements deriving from the ‘necessity for takers of negotiable instruments to tell at a glance whose obligation they hold.’”

It is undisputed that Okobank never dealt with either of the Shulofs or JSF. Mrs. Shulof offers no evidence sufficient to raise a triable issue of fact as to either Okobank’s status as a *holder in due course* or her allegations of fraud in the inducement on the part of FFS. Accordingly, the Court finds that Mrs. Shulof’s signature on the bill of exchange did not give notice that she signed in a representative capacity only, and therefore she is personally liable for the amount of the bill. SO ORDERED.

Case Highlights

- There is a strong public policy in U.S. corporate law against imposing personal liability on corporate officers for actions performed on behalf of the corporation.
- It is customary under Finnish law for an agent to be held personally liable as a surety for goods purchased at an auction.
- A corporate officer who signs a bill of exchange or draft must state she signs *only* in a representative capacity in order to avoid personal liability.
- The public policy underlying negotiable instrument law is that a *holder in due course* may collect against the signer of the instrument.
- A choice of law clause in a contract will be enforced if there is a reasonable connection between the choice and the transaction, unless a strong public policy of the forum court is threatened.
- Owners at an auction have the right to prescribe the manner, conditions, and terms of sale.

Another method used to pierce the corporate veil is **enterprise liability**. Although this theory has been widely rejected by U.S. courts, some foreign courts recognize it. Enterprise liability looks at affiliated companies as an enterprise to be held liable individually or as a whole. Thus, a parent company may be held liable for the acts of its subsidiaries, or a franchisor may be held liable for the acts of its franchisees. Taken to an extreme, each individual subsidiary or franchisee can be held liable for the acts of other subsidiaries or franchisees. This was the path taken by the Grand Court of the Cayman Islands in *Touche-Ross & Co. v. Bank Intercontinental, Ltd.* (Compare, Sandra K. Miller, “Piercing the Corporate Veil among Affiliated Companies in the European Community and in the U.S.: A Comparative Analysis of US, German, and U.K. Veil-Piercing Approaches,” 36 *Am. Bus. L. J.* 73 [1998].) In that case, Touche-Ross of the Cayman Islands performed audit work in the Cayman Islands for Bank Intercontinental. Bank Intercontinental then attempted to sue Touche-Ross International and all its affiliated companies. Touche-Ross of New York brought suit in the Cayman Islands to obtain an injunction against being sued by Bank Intercontinental. The Cayman Court held that Touche-Ross of New York, Touche-Ross of the Cayman Islands, and Touche-Ross International, headquartered in Switzerland, formed a common enterprise. As a common enterprise, the affiliated company was held to be jointly liable for the acts of an associated member.

Establishing a Business in a Foreign Country

The requirements to establish a business or an office in a foreign country vary dramatically from one country to the next. The **least level of involvement** in entering a foreign market is hiring a **foreign sales representative or agent**. Some countries, however, limit foreign companies to hiring nationals as sales representatives or agents. The foreign exporter, however, can exert substantial control over its agents through **management agreements**. Such agreements do not *establish* the foreign exporter for purposes of tax liability; the tax liability of the foreign company is generally restricted to the income of any expatriates assigned to the representative office.

The next level of entry into a foreign market is the establishment of a **representative or branch office**. With a branch office, **the parent company establishes any type of operation**—sales office, manufacturing plant, or distribution facility—**without setting up an independent legal entity**. The branch office generally **operates under the trade name of the parent company**. Advantages of such an operation include **ease in establishment, central management, and fewer required disclosures of confidential information to third parties**. The major disadvantages are the risk of host country taxation and unlimited liability for the activities of the branch office, such as product liability. A business permit is required in most countries, and in some countries, registering to establish a foreign office entails multiple filings with multiple agencies. In Indonesia, the activities of a representative office are limited to signing sales contracts, collecting payments, and other general business activities. In other countries other activities may also be limited.

An important issue in entering a foreign market is the protection of the company’s trade name. In the United States, corporate and trade names are protected under the individual states’ incorporation statutes. Once a business name is reserved, all other persons or companies are precluded from using that or a similar name. In many foreign countries the only avenue of protection for a business name is for a company to register it as a foreign trademark.

Companies planning a permanent presence in a foreign country may choose to establish an independent subsidiary or purchase an existing company. Most countries recognize a variety of limited liability entities similar to what is found in the U.S. For example, the French Civil Code recognizes the individual partnership (general and limited), LLC (ordinary or additional liability), joint stock company (corporation) (open and closed), and the industrial enterprise (state or municipal).

The corporate entity is recognized in almost all countries in the world, but names and abbreviations for corporations vary in different legal systems. In the United States, a corporation is signified by the use of “Inc.” after the company’s name to indicate that it is an “incorporated” entity. The term “Limited” or “Ltd.” is used in Canada and Great Britain. “S.A.” for *Société Anonyme* is the corporate designation in France and Spain. “SpA” or *Società per Azioni* is the Italian symbol for corporation, and “Y.K.” or *Yugen-Kaisha* is the Japanese designation for a corporation. Even though the nomenclature is similar between the types of Russian and U.S. enterprises, there are key differences in the Russian forms of enterprise. For example, the Russian partnership is considered a separate entity

for purposes of taxation, and does not benefit from the pass-through feature of U.S. partnerships. Double taxation, at the partnership and individual levels, is the result.

Another variation not found in U.S. law is the LLC *with additional liability*. The standard Russian LLC, like those in the United States, limits the owners' liability for the debts of the company to the value of their contributions. The LLC with additional liability makes the owners liable for a *pro rata* share of the company's debts in bankruptcy. This form is intended to provide additional security to creditors.

The **joint stock company** is the Russian form of corporation and is regulated under the 1996 Law on Enterprises. Under this law, a joint stock company may be open or closed. The closed version is limited to no more than 50 shareholders who can maintain their ownership interests through a preemptive right to purchase a *pro rata* share of any subsequent issuance of stock. Unlike U.S. laws, this Russian law grants subsidiaries express rights that can be used against the parent company. The parent company is jointly and severally liable for any orders it gives to its subsidiaries. It is also liable for the insolvency of a subsidiary due to the parent company's fault. Finally, shareholders of the subsidiary have the right to sue the parent company for losses caused by the fault of the parent company.⁵

Foreign Competition Law

If the market entry strategy decided upon is the purchase of an existing foreign company, then the legalities of acquiring a company under host country laws must be thoroughly researched, particularly whether the acquisition conforms to the host country's antitrust or **competition law**. The European Union provides one example of an advanced competition law system. In order to purchase a company situated in a European Union country, a purchaser must obtain clearance from Directorate IV of the European Commission. The following *Commission Decision of 17/11/1999* provides insight into the nuances of European competition law.

Commission Decision of 17/11/1999

1999 OJ C 357 (Case No IV/M.1652)

On October 14, 1999, the Commission received a notification of proposed concentration pursuant to Article 4 of Council Regulation (EEC) No 4064/89 of the acquisition by the Belgian company, SA D'Ieteren NV. ("D'Ieteren"), of sole control over the South African company Plate Glass & Shatterprufe Industries Limited ("PGSI"). Following examination of the notification, the Commission has concluded that the notified operation falls within the scope of Council Regulation (EEC) No 4064/89 and does not raise serious doubts as to its compatibility with the common market and with the European Economic Area Agreement (EEA).

D'Ieteren is involved in a range of business activities in the automotive sector, comprising broadly: i) wholesale and retail motor vehicle distribution, ii) servicing and repair and the supply of spare parts for motor vehicles, iii) short-term car rental, and iv) long-term car rental and financing. D'Ieteren has practically no activities outside the EU, and within the EU some 70 percent of its turnover is achieved in Belgium. PGSI is a group involved in the manufacture, distribution, repair, and replacement of glass and board products. It has activities in South

Africa, Central Africa, the United States, Australia, New Zealand, and Brazil, as well as in the EU.

The transaction consists of a number of steps through which D'Ieteren will acquire sole control of PGSI. D'Ieteren will carry out these steps through a joint venture company, S.A. Dicobel ("Dicobel"), in which it will hold 70 percent of the shares. The remaining 30 percent is held by S.A. Copeba Novo (Copeba), a Belgian listed holding company. In the Shareholders' Agreement of Dicobel, Copeba's role is stated to be that of "financial partner," and provision is made for a majority representation by D'Ieteren on the Board, whose majority will make the strategic decisions of the company. Dicobel will, in turn, acquire the majority shareholding of each of three companies, namely, Old Belron Rest of the World, Hold Co Southern Africa, and Glass SA, which between them comprise the PGSI group of companies. Through its majority presence on the Boards of these companies and the arrangements for strategic decision-making, Dicobel will enjoy sole control over PGSI. Thus D'Ieteren, through its sole control of Dicobel, will have sole control of PGSI.

Concentration of a Community Dimension

The operation constitutes an acquisition by D'Ieteren of sole control of PGSI, and is, therefore, a concentration within the meaning of Article 3.1.b. of the Merger Regulation. D'Ieteren and PGSI have a combined aggregate worldwide turnover in excess of EUR 2,500 million. In each of the three member states their combined aggregate turnover is more than EUR 100 million. The operations have, therefore, a Community dimension.

Relevant Product Markets

The activities of D'Ieteren and PGSI, through its subsidiary, Belron International, overlap in two areas, in themselves vertically related, i.e. i) the supply of automotive glass to the independent aftermarket, consisting of independent car dealerships, garages, and body shops ("IAM"), which the Commission has already considered to constitute a product market in itself; and ii) the repair and replacement of automotive glass, which would constitute another product market.

Relevant Geographic Markets

The IAM market has already been considered to be of a Community-wide geographic scope by the Commission, and this definition is retained in the present case. With regard to the repair and replacement of automotive glass, D'Ieteren submitted that the existence of national distribution networks with national pricing and single (free call) telephone numbers indicated a national geographic scope for this market. Other characteristics, such as different suppliers in different member states and appreciable price differences from one member state to another, can be considered further indicators of a national scope for the market for these services. However, given that the operation does not raise any serious concerns, either at a national or wider level (D'Ieteren does not have these activities outside of Belgium), the Commission does not need to define the geographic scope of the market for the repair and replacement of automotive glass more precisely in the present case.

Assessment—The Repair and Replacement of Automotive Glass

The repair and replacement of automotive glass would constitute an affected market in Belgium, due to the

addition of PGSI/Belron's share of some 39 percent to D'Ieteren's own share of some 1 percent. D'Ieteren's activities have been limited to services provided in its own car dealerships situated in the Brussels area, whereas PGSI/Belron operates from a network of 40 branches throughout Belgium, replacing the glass at the branches or at the location chosen by the customers. Although the operation strengthens considerably D'Ieteren's market share, the actual change brought about in the overall structure of supply in the market is very small indeed, given D'Ieteren's very limited share. Furthermore, D'Ieteren has indicated that it will be confronted with competition from a variety of competitors, including: (i) independent service providers who market as a single source and supply a network assistance of the type provided by PGSI/Belron, which between them enjoy some 5 percent to 15 percent of the market; (ii) independent car dealerships who as a block account for some 25 percent to 35 percent; and (iii) body shops and garages who make up the remaining 15 percent to 25 percent or so of the market. The Commission's market investigation did not result in the expression of any significant concerns by the other players with regard to the competitive impact of the operation. In the circumstances and in the light of the factors mentioned above, i.e. the marginal change in market structure and the range of competitors, the Commission considers that the operation will not lead to the creation or strengthening of a dominant position in the repair and replacement of automotive glass in Belgium.

For the above reasons, the Commission has decided not to oppose the notified operation and to declare it compatible with the common market and the EEA Agreement.

Case Highlights

- Directorate IV of the European Commission is responsible for the enforcement of EU Competition Law.
- Before acquiring a European company, a foreign investor should *notify* (consult) with Directorate IV.
- Factors used to determine whether an acquisition or merger will create a *dominant position* (monopoly) subject to abuse include whether the acquisition has a community dimension, the relevant product markets, the geographic scope of the market, and the market shares of the companies.

For more information on EU competition law, see Chapter 8, “The European Union.”

Foreign Trade Zones

A foreign or free trade zone can minimize legal exposure in a foreign country. Foreign and domestic merchandise may enter the designated foreign trade zones without a formal customs entry. Therefore, importation and subsequent re-exportation are not subject to customs duties or excise taxes. While in the trade zone, the merchandise may be:

- stored
- sampled
- relabeled
- repaired
- assembled
- processed
- tested
- displayed
- repackaged
- cleaned
- manufactured
- mixed

If the final product is exported, no customs duty or excise tax is levied. If the final product is imported into the country, then customs duties and excise taxes are due at the *time of transfer* from the foreign trade zone and formal entry into the country. The fact that duties are due only at the time merchandise is transferred out of the trade zone can be used by foreign exporters to improve their cash flow by shortening the time between paying customs duties and receiving income from the sale of goods. A foreign exporter may ship unsold goods into a trade zone for storage purposes without incurring the costs of duties or formal entry. The goods may be transshipped without penalty, or prospective buyers can inspect goods and rejected goods can be transferred out or destroyed duty-free. Foreign trade zones are found in many countries in the world and conform to the free trade principles of GATT. For a fuller discussion of free trade zones see Chapter 7 on “Free Trade Agreements.”

International Taxation

No matter what vehicle is chosen to transact foreign business operations, the foreign investor is subject to the tax ramifications of doing business across national borders. International taxation is one of the most complicated issues of doing business internationally, because taxation is dealt with differently among the countries of the world. In the United States, for example, citizens or resident aliens must pay federal income tax on their worldwide income. International tax treaties and federal statutes grant certain exemptions, deductions, and credits in order to protect against being double-taxed by two countries.

In the United States, nonresident aliens are taxed only on their U.S. source business income—a nonresident alien providing services within the United States for either a foreign or U.S. employer must pay U.S. income tax on wages or compensation received for services. However, nonresident aliens are exempt from paying income tax in the United States if: (1) their stay in the United States does not exceed 90 days in any one taxable year, (2) their compensation does not exceed \$3,000 (or \$10,000 for Canadian residents), and (3) the services are performed for a foreign employer not currently engaged in business in the United States. In contrast, resident aliens in the United States are taxed the same as U.S. citizens on their worldwide income.

Joint Ventures and Franchising

An **international joint venture or franchising arrangement** is attractive for a number of reasons.⁶ First, it allows a party to **utilize the partners or franchisees’ local expertise, marketing skills, and established lines of distribution.** Joint ventures and franchises are well suited for entry into a foreign market through the use of a host country national familiar with the local language, law, and culture. Second, a joint venture or franchise **may provide a means**

to avoid host country protectionist trade requirements. Joint ventures, for example, are used to provide technology to a foreign partner who has production facilities and access to the local market. It should be noted that the term “joint venture” is not legally defined in some foreign legal systems. It is important to research foreign law to familiarize oneself with the forms of doing business recognized under the national law that can be utilized to approximate the joint venture concept.

Joint Ventures

International joint ventures are used in a wide variety of manufacturing, mining, and service industries and are frequently undertaken in conjunction with technology licensing by the U.S. firm to the joint venture. The host country may require that a certain percentage, often 51 percent, of manufacturing or mining operations be owned by nationals of that country, thereby obligating U.S. firms to operate through joint ventures. In addition, U.S. firms may find it desirable to enter into a joint venture with a foreign firm in order to spread the high costs and risks frequently associated with foreign operations. Moreover, the local partner may bring to the joint venture its knowledge of the customs and tastes of the people, an established distribution network, and valuable business and political contacts. Having local partners also decreases the foreign status of the firm and may provide some protection against discrimination or expropriation, should conditions change.

There are, of course, possible disadvantages to international joint ventures. A major potential drawback to joint ventures, especially in countries that limit foreign companies to 49 percent or less participation, is the loss of effective managerial control. A loss of effective managerial control can result in reduced profits, increased operating costs, inferior product quality, and exposure to product liability and environmental litigation and fines. U.S. firms that wish to retain effective managerial control will incorporate this issue in negotiations with the prospective joint venture partner and frequently the host government.

Like technology licensing agreements, joint ventures can raise U.S. or foreign antitrust issues in certain circumstances, particularly when the prospective joint venture partners are major existing or potential competitors in the affected national markets. Firms may wish to consider applying for an **export trade certificate of review** from the Department of Commerce or a **business review letter** from the Department of Justice when significant federal antitrust issues are raised by the proposed international joint venture.

U.S. firms contemplating international joint ventures should also consider retaining experienced legal counsel in the host country. It may be disadvantageous for a U.S. firm to rely upon its potential joint venture partner to negotiate approvals and advise on legal issues, since its prospective partner’s interests may not always coincide with its own. Qualified foreign counsel can be very helpful in obtaining government approvals and providing ongoing advice regarding the host country’s patent, trademark, copyright, tax, labor, corporate, commercial, antitrust, and exchange control laws.

Joint Venture Agreement

A simple definition of joint venture is “a contract that creates a partnership for the purpose of performing some kind of business operation.”⁷ It is a business collaboration in which the joint venture participants share resources, risks, and profits. Joint ventures often involve joint management and are established for a specific objective and sometimes for a fixed duration. In order for a joint venture to succeed, it must be carefully thought out and researched by all the prospective partners. “Feasibility studies are undertaken, confidential information is exchanged, and huge amounts of money are committed”⁸ before parties enter a joint venture contract. The parties must move cautiously in order to gain the trust of other participants; the parties’ capacities, motives, prior relationships, and project objectives should be fully discussed during the preliminary stage of the negotiations.

A joint venture is an elastic vehicle for doing business and can take numerous forms. For example, the parties can enter into an agreement to work together in order to achieve certain business goals as joint venturers, or they can agree to create an entirely separate entity, such as a corporation, in order to transact business. Two of the common uses of the joint venture in conducting international business are the single project and business alliance joint ventures.⁹

The single project venture exists when a number of parties or companies agree to enter into a partnership in order to develop specific business opportunities with a single, identifiable goal. These single project joint ventures generally have a relatively short life span. An example would be a joint venture for a single construction project. The business alliance venture envisions a more fluid, long-term business relationship.

Under U.S. law, a joint venture is generally considered a general partnership. The core issues in the partnership agreement include the scope of the business enterprise, the capitalization of the venture, the organization and management of the venture, and the termination of the business. A major concern in most joint venture agreements is providing the mechanisms for decision-making. The joint venturers may disagree on how best to deal with post-formation events. It is important, especially in the long-term joint venture agreement, to provide a mechanism to prevent decisional deadlock.

In negotiating and structuring joint ventures, proper attention should be given to the issues of share allocation, financing the enterprise, protecting minority interests, confidentiality, and the transfer and continuation of the business. Shares may be allocated based upon each party's contribution, or joint venturers may authorize different classes or types of shares in order to attract other investors such as venture capitalists. Funding decisions have a direct impact on the location of profits for tax purposes. Investors may structure their contributions as either equity contributions or loans and should give full consideration to all accounting and tax ramifications. For example, one would like to avoid the European Union's 1 percent duty on company capital.

The **purpose clause**, which maps the scope and goals of the business enterprise, is crucial for maintaining the long-term viability of the joint venture arrangement. Scope should be defined along three parameters: geography, products and services, and duration. A careful balance must be struck between a clause that is precise but restricts future expansion and one that allows the venture to develop in different directions, since an overly specific statement of the venture's purpose can lead to an undesirable termination. This can be accomplished by a specific purpose clause coupled with an **exceptions clause** that allows for adjustments to the purpose clause along prescribed parameters. An alternative provision would allow for a periodic review of the purpose clause with a renegotiation requirement.

Joint venturers must also establish the initial level of capitalization, including the amount and form of currency to be invested by each partner and a method for adjusting foreign currency differences. If non-currency contributions are contemplated, the agreement should specify a valuation method. Also, the parties should expressly agree to the adoption of accounting standards such as United States or EU accounting standards and practices. The agreement should also specify the level and type of indebtedness the venture is authorized to undertake by establishing an acceptable debt-to-equity ratio.

A successful joint venture agreement will provide the means to make future funding decisions. The most likely cause of joint venture failure is the parties' disagreement regarding future capital infusions. If external funding is likely to be sought in the future, an agreement is needed as to whether the joint venture partners will provide guarantees in order to procure external financing. The joint venture agreement should also have a **counter-indemnity clause** in which the joint venture partners agree to be responsible on multiple-party guarantees to the proportion of their shareholdings.

If the joint venture is between numerous parties, then provisions to protect minority interests may be necessary. One way to protect minority interests is to categorize decisions as "ordinary" or "extraordinary." Extraordinary decisions would require a supermajority vote for approval; for example, a two-thirds or 75 percent vote would be required to approve extraordinary decisions. Extraordinary decisions could include:

- capital expenditures in excess of a certain amount;
- borrowings in excess of a certain amount;
- increasing of share capital;
- issuance of new stock or admittance of a new joint venture partner;
- giving guarantees, and appointment or removal of directors;
- setting employee remuneration above a certain level;
- material changes in the business operation or nature of the business;

- sale or transfer of assets;
- making contracts with principals of the joint venture;
- approval of budgets.

In case of a deadlock regarding an important decision, a party may be offered the right to leave the joint venture; a provision should address the transfer or sale of ownership to the other partners. Share price should be fair, to be determined by an independent accounting firm. The shares being sold should be offered to all remaining partners in proportion to their existing ownership interests. The agreement should also provide whether, in the event of termination, the joint venture partners have the right to continue in the same business after the termination.

Strict confidentiality and noncompetition provisions are also necessary. The partners may be prohibited from competing with the joint venture by stipulations that include being unable to hire employees of the joint venture for a period of time, maintaining the secrecy of all confidential information, and not soliciting customers of the joint venture. Of course, these restrictions must be reasonable or may be subject to challenge as illegal restraints of trade under U.S. common law or the EU's competition law pertaining to ancillary restrictions.

Another crucial set of provisions to ensure the ongoing viability of the venture is the management provisions. *Double parenting* is a pervasive problem in which both joint venturers attempt to assert independent control over the joint venture. The degree of managerial control to be placed with the different joint venturers should be carefully delineated in the agreement. Will the owner of the greater share have greater managerial control? Will a local minority partner be allowed a degree of control greatly exceeding its proportional ownership? Other issues that will need to be dealt with by management clauses include: (1) Should veto power be given to the partners, including minority partners, for particular classes of important decisions? (2) How will the selection of the top manager and management team be decided? (3) What reporting and information systems will be used to communicate between the joint venture and its owners?¹⁰ Ultimately, these provisions will reflect the essential nature of the joint venture as one controlled by a dominant parent or as one with a shared management structure.

Finally, the joint venture should have a detailed termination provision stating the events that allow the parties to terminate their involvement. The following list suggests the types of considerations that should be discussed in drafting a termination clause:¹¹

- failure of a participant to make required capital contributions;
- failure of a participant to obtain necessary government approvals;
- failure of the venture to reach a pre-agreed level of profitability;
- management deadlock;
- failure of one partner to purchase the shares of another (buy-sell agreement);
- an adverse and debilitating change in the law;
- bankruptcy or insolvency of one of the participants.

The termination clause should also describe how unforeseeable or *force majeure* events will affect a termination of the joint venture.

Ancillary Agreements

The joint venture agreement is likely only one of a number of documents to be prepared for a well-planned joint venture undertaking. Other documentation commonly used includes a formal business plan, distribution agreement, intellectual property transfer or licensing agreement, management agreement, service contracts, and secondment agreements. A carefully written business plan is vital to maintaining cordial relationships among the joint venture partners. It should be sufficiently long-term in nature, set realistic revenue and profit goals, and provide for a "cushion" in capital and time in meeting the plan's objectives. The business plan should include other necessary studies such as a long-term strategic plan and a marketing plan.

Secondment agreements are used to require the “lending” of employees of the joint venture partners to the joint venture. It is important to determine whether these employees are to be treated as independent contractors or employees of the joint venture. From the point of view of the joint venture, treatment as independent contractors is preferred. The joint venture partner would then remain primarily obligated to the employees being lent. Service contracts between the partners and their joint venture could also be utilized in the management of the joint venture enterprise.

Sometimes, one of the joint venture partners is given the formal responsibility to manage the joint venture. In that case, the managing partner should enter into a formal management agreement with the joint venture. The management agreement, among other things, should outline the allocation of costs between the partner’s core business and the joint venture business. Often one of the contributions of a joint venture partner is its expertise in its home country regarding the distribution of goods or services. An express **distribution agreement** should be entered into between that partner and the joint venture. The distribution agreement’s termination provisions should be tied to those in the joint venture agreement. This may be important if the distributor is removed as a joint venture partner.

International joint ventures may include the use of the know-how or intellectual property rights of one of the joint venture partners. In such a situation, an independently negotiated **intellectual property transfer** or licensing agreement is necessary and should deal with the withdrawal of the licensor-partner. A name change of the joint venture may be required if the existing name is associated with the intellectual property of the withdrawing partner. The licensor-partner may demand a provision that makes the licensing of intellectual property rights dependent on the licensor’s continued involvement in the joint venture. For more information on joint venturing, see Chapter 20 on “Foreign Direct Investment.”

Foreign Government Regulation

Foreign governments commonly regulate joint venture transactions. The most common restrictions are foreign participation requirements in which control of the enterprise must vest in a local company. The trend, however, has been toward a liberalization of such participation requirements. Figure 3.3 *Doing Business Internationally: “Joint Ventures and Licensing in Indonesia”* summarizes the practice and law of joint venturing in Indonesia. Note that it is now possible for a foreign investor to obtain almost total ownership of an Indonesian joint venture.

Unique types of government regulations can be found on a country-by-country basis. For example, the People’s Republic of China enacted Regulations on Labor Management in Foreign Joint Ventures. It requires that a labor contract, approved by the Chinese government, be entered into between the joint venture and a trade union. It further provides that all workers of the joint venture “shall be selected for employment through examinations conducted by the joint venture.” The joint venture’s ability to discharge employees is also restricted. “Punishment by discharge must be reported to the department in charge of enterprises and the labor management department for approval.” China’s more generic law on joint ventures, the Law of the People’s

The Indonesian government has removed most requirements for domestic equity and joint ventures. Foreign investors who opt for 100 percent initial ownership are obligated to divest to Indonesians some share—as little as 1 percent—after 15 years. This can be accomplished through the stock market. As a practical matter a local joint venture partner is often essential for success in this market, for the same reason that an Indonesian agent or distributor has advantages over a foreign trade representative office. The choice of an Indonesian joint venture partner is critical for many reasons, especially for knowledge of the local scene and contacts, which are important for successful

operations. A partnership in Indonesia is difficult to dissolve, however, so the first choice has to be the correct choice. Business sense is crucial to any commercial endeavor, and contacts in Indonesia, while important, cannot substitute for business skills in a local partner. Since Indonesians place great importance on personal relationships and mutual understanding, partnerships tend to be based primarily on genuine accord, with the written contract playing a less significant role. It is therefore important that any agreement be well understood by both sides. A contract over which there are conflicting interpretations is certain to cause future problems.

Figure 3.3 *Doing Business Internationally: Joint Ventures and Licensing in Indonesia.*

<p>Step 1: Signing of Cooperative Joint Venture Contract</p> <p>Step 2: Submission of Joint Venture Contract and Articles of Association to the “Examination and Approval Authority” (as designated by the State Council) [Approval Authority must render a decision within 45 days]</p> <p>Step 3: Application for Registration (to appropriate industry and commerce agency) [Within 30 days of receipt of approval certificate from Approval Authority]</p>	<p>Step 4: Receipt of Business License (date of establishment)</p> <p>Step 5: Register Venture with appropriate tax authority</p> <p>Step 6: Post-establishment concerns</p> <ul style="list-style-type: none"> • Any changes in the joint venture contract must be submitted to the Approval Authority. • Record-keeping and certifications must be verified by a registered Chinese accountant. The joint venture must establish and support a labor union to represent its employees. • Open a foreign exchange account.
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Figure 3.4 *Doing Business Internationally*: Establishment of a Joint Venture in China.

Republic of China on Chinese-Foreign Cooperative Joint Ventures should be carefully reviewed before beginning any negotiations. See Figure 3.4 *Doing Business Internationally*: “Establishment of a Joint Venture in China.” It provides that the parties should agree in a *cooperative venture contract* on the terms and conditions of cooperation, the distributions of earnings or products, the sharing of risks and losses, the form of operation and management, and the ownership of property. All such contracts need to be approved by the relevant examination and approval authorities. As with any major foreign venture, firms are strongly advised to locate and retain a local attorney early in the investment process.

The list in Figure 3.4 demonstrates that governmental regulation is pervasive in the establishment and operation of a joint venture in China. The cooperative joint venture law is merely a framework or enabling statute; detailed regulations must be consulted before establishing a joint venture. Also, ancillary laws must be reviewed in conjunction with the operation of the joint venture. Article 13 of the Chinese law states that “matters such as employment, discharge, remuneration, welfare, labor protection, and labor insurance should be stipulated through the making of contracts in accordance with the law.” In fact, a foreign investor is required to enter into a labor contract as a condition for joint venture approval. The labor contract must be submitted to the municipal or provincial government for approval. Furthermore, the labor–management relationship is regulated throughout the term of employment. Most workers are hired from a pool of workers provided by the local government labor department. They are to be selected for employment through an approved examination. Finally, any discharge of an employee must be reported to the labor management department for approval. When contemplating a joint venture in China it is good practice to obtain copies of form contracts (available in English) used by Chinese enterprises and to consult with the Chinese Ministry of Foreign Economic Relations and Trade (MOFERT) created in 1982 to expedite foreign trade contracts.

Franchising

There are different types of franchising arrangements, including: (1) production or manufacturing, (2) distribution franchise, (3) developer agreements, and (4) master franchise agreements. In **production franchises** the **franchisor licenses its trademark to the licensee, who is then authorized to manufacture according to franchisor specifications and to market the product.** In a **distribution franchise**, the **franchisor produces the goods and sells them to the distributor franchisee for resale to the final consumer.** In a **territorial franchise**, also known as area developer agreements, the **franchisor gives the franchisee the right to develop an entire territorial area.** The franchisee determines, possibly in consultation with the franchisor, how many locations to establish in the territorial area. The **master franchise agreement** **allows the franchisee to sub-franchise, meaning the franchisee does not have to want every location, but may assign those rights to other parties.** Such an arrangement **creates a chain of relationships:** master franchisor to master franchisee/sub-franchisor to sub-franchisee.

Though franchising is an attractive arrangement, it does pose some problems. Franchising is a uniquely U.S. form of doing business. Franchising is allowed in most countries of the world, but many foreign laws do not expressly recognize the franchise form of business. For example, even though franchises have been registered in Germany, franchising itself has not been explicitly codified in German law, so other more general bodies of law, such as licensing or partnership law, are used by analogy to regulate the franchise relationship. In Germany, franchises are regulated through application of German commercial, trademark, competition, and consumer credit law.

Since the franchise is not expressly recognized in some countries, imposing exclusive franchise territories is susceptible to attack under foreign competition or antitrust laws. In Europe, an EU **block exemption** that provides a general exemption from the ban on cartels for franchise arrangements has alleviated the problem. The EU block exemption has resulted in the franchise industry in Europe being primarily self-regulated. The European Franchise Federation acts as an umbrella organization for the different national franchise associations, guiding those promoting franchise operations. The European Franchise Federation has issued a code of ethics that should be reviewed by a foreign party intending to franchise in Europe. National franchise associations have also issued guidelines, such as the German Franchise Association's Pre-Contract Disclosure Requirements.

Before entering into a franchising contract with a foreign entity, it is important to thoroughly research the investment climate in the host country. For example, in Indonesia, franchising became a popular vehicle for foreign entry until the devaluation of the rupiah, which made it difficult for franchisees to pay their franchise fees that needed to be made in a hard currency (USD, euro, yen, British pound). Aside from the convertibility issue, Indonesia places no major restrictions on the repatriation of profits and maintains no capital controls, so foreign exchange may flow freely in and out of the country. Foreign investors have the right to repatriate capital and profits at the prevailing rate of exchange.

The U.S. State Department's *Commercial Guide for Indonesia* summarizes the law pertaining to franchising as follows:

Although there is no specific law regulating franchising, the legal underpinnings for franchising are specified in article 1338 of the Indonesian Civil law (KUH Perdata—Kitab Undang Hukum Perdata) which states that business persons are free to conclude contracts. Further legal grounding for franchising can be found in the 1992 law on trademarks No. 19, article 44–50.

There are no widely accepted models for business contracts covering franchise agreements. However, the foreign principal usually provides the franchisee with his own standard contract format, which is used as a basis for developing franchise agreements with the local business enterprise. The franchise agreement should be reviewed and notarized by a public notary in Indonesia in order to make it legally binding.

Franchise agreements should be accompanied by other contractually binding arrangements such as loan agreements, site leases, building agreements, graphics, employee selection, standard description and promotion. Franchise agreements should also include a provision regarding the settlement of disputes through arbitration which may arise out of breach of contract or disagreements between the contracting parties.

Because Indonesian law does not prescribe any specific form or registration requirements for franchise agreements, the foreign franchisor is free to use its own standard forms.

The State Department Guide notes that joint venturing with an established Indonesian company is the preferred method of market entry. This means of market entry has been enhanced by recent developments. First, in 1994 the Indonesian government removed most local participation requirements. Second, a number of firms will provide background and credit checks on Indonesian firms. Third, an Indonesian company can provide the necessary knowledge and contacts with the local market. As noted above, one drawback to establishing an Indonesian franchise relationship is the difficulty of dissolving a joint venture or franchise partnership under Indonesian law. Therefore, careful background research, prior dealings, and a clear, comprehensive agreement are necessary.

Other areas of interest for those contemplating franchising, licensing, or joint venturing in a foreign country include the protection of intellectual property rights (IPR), the use of a local attorney, transferability of ownership interests, and expropriation and dispute settlement policies. Intellectual property laws are not always enforced in Indonesia, which requires creative strategies to protect IPR, such as the strategy of identifying counterfeiters and then proceeding to sign them as legal licensees. Nonetheless, it is important to register intellectual property as soon as possible and to challenge any unauthorized registrations. The Commercial Guide suggests acquiring a local partner as the best way to defend against the infringement of IPR.

As with the record for intellectual property protection, the Indonesian record for the enforcement of foreign arbitration awards is dismal. In the area of dispute resolution, Indonesia is a party to the *New York Convention* on the enforcement of foreign arbitration awards, but because an Indonesian court is more likely to enforce an award issued by an Indonesian arbitration panel, the Guide suggests an arbitration clause that designates Indonesia as the place of arbitration. The transfer and expropriation policies of the Indonesian government are conducive to foreign entry. Foreign investors have the right to repatriate capital and profits, and no permits are required to transfer foreign exchange.

Franchise Law

The advantage of franchising is that it is an efficient a method for facilitating the transfer of know-how and expertise to franchisee companies, while simultaneously **allowing the franchisor to quickly establish a presence in the country**. In typical franchise agreements, **the franchisor receives royalties and fees in exchange for the franchisee's use of the franchisor's IPR and confidential information to sell services or produce products**. The franchisor typically provides training and guidance.

The expertise of the franchisor is reflected in areas of the franchise contract including the opening and financing of the franchise, along with the means and content of advertisement. Contractual clauses pertaining to the franchisor's assistance in obtaining financing and opening the franchise should state specific obligations. In the area of advertisement, the clause should state the franchisor's control over the content and placement of advertisements. Also, it may mandate a minimum level of franchisee expenditures on advertisements.

Some franchise agreements provide for a pool of funds contributed by franchisees that the franchisor then uses to place advertisements. The franchise agreement should detail how advertising monies are to be spent by the franchisor. The franchisees may request a clause allocating advertising monies between a national or international campaign and local advertisement. The *Broussard v. Meineke Discount Muffler Shops* case involves a dispute over such an advertisement provision. It illustrates some of the nuances of U.S. franchise law and how courts are reluctant to pierce the limited liability protection that franchising offers to the franchisor.

Broussard v. Meineke Discount Muffler Shops

155 F.3d 331 (4th Cir. 1998)

Wilkinson, Chief Judge. This case is a study in the tensions that can beset the franchisor–franchisee relationship. Ten owners of Meineke Discount Muffler franchises sued franchisor Meineke Discount Muffler Shops, Inc. (“Meineke”), Meineke’s in-house advertising agency New Horizons Advertising, Inc. (“New Horizons”), three officers of Meineke, and Meineke’s corporate parents GKN and GKN Parts Industries Corporation (“PIC”). Plaintiffs claimed that Meineke’s handling of franchise advertising breached the Franchise

and Trademark Agreements (“FTAs”) that Meineke had entered into with every franchisee. Plaintiffs also advanced a raft of tort and statutory unfair trade practices claims arising out of the same conduct. Plaintiffs won a \$390 million judgment against Meineke and its affiliated parties.

Under all versions of the FTA, each franchisee was to pay Meineke an initial franchise fee and thereafter some percentage of its weekly gross revenue (generally 7 percent to 8 percent) as a royalty. Franchisees also paid

Meineke 10 percent of weekly revenues to fund national and local advertising. Initially, franchisees made these advertising contributions directly to a third-party advertising agency, M&N Advertising ("M&N"), which placed ads on a commission basis. In 1982, franchisees paid their 10 percent contributions to a central account maintained by Meineke, the Weekly Advertising Contribution ("WAC") account.

Franchise advertising is addressed in two sections of the FTAs. All versions of the FTA oblige Meineke "to purchase and place from time to time advertising promoting the products and services sold by FRANCHISEE." The FTAs provide that "all decisions regarding whether to utilize national, regional, or local advertising, or some combination thereof, and regarding selection of the particular media and advertising content, shall be within the sole discretion of MEINEKE and such agencies or others as it may appoint." Three categories of disbursements from the WAC account, totaling approximately \$32.2 million, are at the heart of this lawsuit. At a dealers' meeting in April 1993, a Meineke official read from a December 1992 Uniform Franchise Offering Circular ("UFOC") that disclosed New Horizons' 5 percent to 15 percent commission rates. Plaintiffs knew before the meeting that New Horizons took commissions from WAC funds but claim they were unaware that its rates were so high.

The jury returned a verdict against Meineke for breach of contract and against Meineke and New Horizons for breach of fiduciary duty, negligence, and unjust enrichment. The jury found that GKN and PIC had utilized Meineke and New Horizons as mere instrumentalities, and that PIC was merely an instrumentality of GKN, which justified piercing the corporate veil and imposing vicarious liability on GKN. Along with Meineke and New Horizons, GKN, PIC, and three officers of Meineke were found to have committed fraud, and of making negligent misrepresentations. The jury awarded plaintiffs \$196 million in compensatory damages, which, over Meineke's objection, was not allocated among the various theories of liability or among defendants. The jury awarded a total of \$150 million in punitive damages: \$70 million against Meineke; \$7 million against New Horizons; \$1.8 million against PIC; \$70 million against GKN; and \$1.2 million total against the three Meineke officers.

The district court erred by allowing plaintiffs to advance their claims for breach of fiduciary duty when there is no indication that North Carolina law would recognize the existence of a fiduciary relationship between franchisee and franchisor. "Rather," in North Carolina, "parties to a contract do not thereby become each others' fiduciaries; they generally owe no special duty to one another beyond the terms of the contract and the duties set forth in the U.C.C." Though plaintiffs would portray franchisees as helpless David's to the franchisor's Goliath, size, as that story teaches, is not a reliable indicator of strength or influence. Our hesitation is strengthened by the refusal of courts in many other jurisdictions to superimpose fiduciary duties on a franchisor-franchisee relationship.

Furthermore, shareholders who take an active interest in the affairs of the corporation are "non-outsiders" and thus protected from tortious interference claims by the same qualified privilege that protects directors and officers of the corporation. And if those shareholders do not completely dominate the affairs of the corporation, the corporate veil will not be pierced and they will be shielded from vicarious liability. Setting up such a safe harbor preserves the advantages of limited liability while encouraging shareholders to actively monitor corporate affairs.

REVERSED AND REMANDED.

Case Highlights

- The franchise arrangement is contractual in nature, however, U.S. regulations require certain disclosures through a Uniform Franchise Offering Circular (UFOC).
- Because of the contractual nature of the franchise arrangement, the franchisor does not owe a fiduciary duty to its franchisees.
- Note the size of the punitive damages component of the jury award. Punitive damages are unique to American law and are not found in foreign legal systems.
- Note also that the corporate veil will only be pierced to hold shareholders or a parent corporation vicariously liable when the shareholders or parent exercises complete *domination* over the corporation or its subsidiary, or if they fail to observe corporate formalities.

The franchise relationship is a uniquely American creation. "Over half a million franchises operate in the United States, and they account for more than a third of the nation's total retail sales."¹² The United States has developed an extensive body of law regulating the franchise relationship: A large number of states regulate the offer and sale of

franchises; many state laws require franchisors to register a detailed offering before being able to solicit franchisees; some statutes provide the franchisee with a right to cure any of its defaults under the franchise agreement and grant a minimum notice period prior to termination by the franchisor. The popularity of franchising in the United States, along with this increased governmental regulation, has produced a number of franchise clauses that are commonly used and recognized in the franchise industry. The next section will review some of the clauses commonly found in the franchise agreement.

The Franchise Agreement

The following commonly used clauses place various obligations upon the franchisor and the franchisee. These clauses should be completely understood when negotiating a franchise agreement. A **site selection clause** delineates the franchisor's responsibilities in the site selection process. Such clauses range from placing an affirmative duty on the franchisor to find an appropriate site to simply requiring the franchisor's approval. An approval clause should state the criteria for the franchisor's disapproval of a site. In *Brennan v. Carvel Corp.*,¹³ the court went outside the boundaries of the franchise site selection clause in finding that the franchisor had failed to meet its obligations in the site selection process. The court found the franchisor's Deposit Agreement stated that the franchisor would expend a "substantial amount of time and effort in seeking, surveying, and showing locations available for a store." This case illustrates the importance in reviewing all franchise documentation for consistency. A merger clause (centre agreement clause) in the final franchise agreement is unlikely to prevent courts from reviewing preliminary agreements, ancillary agreements, promotional materials, and governmental filings for purposes of clarification or to substantiate a claim of misrepresentation.

Physical layout and signage, along with operational standards, are important areas of control for the franchisor. Clauses relating to these matters are essential to maintain system-wide integrity and uniformity of standards. Most retail franchises utilize layouts that maintain the uniformity of appearance at all franchise locations. The appearance (design or display) of the franchise location may be protected by a separate trademark (trade dress) or be composed of a variety of trademarks, service marks, and copyrights. Failure of the franchisee to adhere to these and other operational standards generally provides the franchisor with good cause for termination of the franchise operation. Most layout clauses give the franchisor the absolute right of approval.

An **operational standards clause** provides a detailed description of quality standards and operational goals. It generally refers to an operating manual provided by the franchisor. In order to defend a decision to terminate, the franchisor should ensure that the franchise agreement has a clear notice provision and provides for a reasonable period of time to cure deficiencies. An associated concern is the training of the franchisee and its employees, since training and consultation provided by the franchisor are the heart of many franchise arrangements. Key employees of the franchisee are trained in all facets of the business. Consultation involves dealing with problems that occur from time to time. A franchisor's failure to provide adequate training and consultation under these clauses would be grounds for a lawsuit by the franchisee.

Most franchise systems are premised on uniform treatment between the franchisor and all its franchisees. However, franchisors sometimes incorporate a clause in their franchise agreements that allow them to vary contractual terms among their different franchisees. Such clauses have been grounds for claims of discriminatory treatment. Other common clauses include those on territorial exclusivity and protection, noncompetition, transfers and assignments, terminations and nonrenewals, and those pertaining to pricing, purchase of supplies, hours of operation, franchisor's rights of inspection, and audits. **Territorial clauses** grant the franchisee an exclusive territory within which the franchisor is barred from competing. The problem with such clauses is that the franchisor and franchisee may disagree regarding the scope of expansion of franchise operations within the territory. An alternative is to give the franchisee a period of time to fully develop the franchise territory. After the expiration of that time, the franchisor is then allowed to further develop the territorial market. The franchisee is protected somewhat by being granted a right of first refusal for any new locations within the territory.

The termination of the franchise by the franchisor, either for cause or nonrenewal, is the action most likely to lead to litigation. Most franchise agreements contain a clause that allows the franchisor to terminate for any violation.

However, termination for a minor breach will not be viewed favorably in most courts. Likewise, the **renewal clause** often provides an absolute right of the franchisor not to renew. Instead of absolute rights to terminate or not to renew, termination or nonrenewal clauses should specify the violations that are considered material for termination and grounds for nonrenewal. Appropriate grounds for termination or nonrenewal include the loss of a lease, failure to operate the business, franchisee insolvency, denial of franchisor access to inspect, and repeated violations of quality standards. Internationally, termination without good cause or without a reasonable period to correct deficiencies will be vulnerable to legal challenge. In the United States, a number of state statutes require good cause for the termination of franchises.¹⁴

Other provisions deal with the mechanics of the franchise relationship. Foremost is the franchise fee or **royalties clause**. The franchise agreement commonly requires that an initial fee be paid for the right to obtain a franchise and then payment of royalties based upon a percentage of gross or net sales. The agreement should provide a commencement date and expiration date. One common means of fixing the dates is to provide for expiration after a certain number of years from commencement or the date the franchise opens for business. Since most franchise arrangements include the transfer of IPR, the agreement should expressly retain the title to those rights to the franchisor. See Figure 3.5 *Comparative Law: “Intellectual Property Transfer Clause,”* which illustrates a franchise clause dealing with the transfer of trade secrets and intellectual property. The clause makes clear that the franchisor owns the intellectual property being licensed and that on the franchise’s termination all of the property rights return to the franchisor.

The final two clauses to be discussed are the insurance and the franchisee review clauses. It is prudent for the franchisor, especially in the international setting, to require the franchisee to maintain certain types and amounts of insurance. The franchisee can be required to carry specific amounts of comprehensive general liability and products liability insurance. The contract should provide that the franchisor should be an “additional endorsee” on all such policies. The **insurance clause** should be coupled with a hold harmless clause that requires the franchisee to defend the franchisor against any liability claims arising from or related to its operation of the franchise.

The **franchisee review clause** is used to combat future claims of misrepresentation or overbearing by the franchisor. They generally incorporate a number of provisos including “a statement that the franchisee has received no guarantees, representations, warranties or the like as to the profitability of the franchise being purchased and that the franchisee has conducted its own independent investigation of the merits of the investment.” Another clause vital to the franchisor’s defense against misrepresentation is the merger clause. The merger clause attempts to prevent the entry of any parol evidence (evidence outside the “four-corners” of the written contract) in a subsequent adversarial proceeding. The role of parol evidence in contract disputes will be discussed in Chapter 11, “Comparative and International Contract Law,” and Chapter 12, “International Sales Law.”

UNIDROIT Guide to International Master Franchising

One way to avoid entering multiple franchise agreements with individual franchisees in a foreign country is the **master franchise** arrangement. In the master franchise arrangement, the franchisor enters into an agreement with a sub-franchisor or master franchisee in order to develop an entire franchise territory. The sub-franchisor is

FRANCHISEE acknowledges that ownership of all right, title, and interest to the ABC franchise system and its marks are and shall remain vested solely in the franchisor, and the FRANCHISEE disclaims any right or interest therein or the goodwill derived therefrom. FRANCHISEE agrees that all materials loaned or otherwise made available to him by the franchisor at any time before or during the term of this Agreement relating to the franchise system, including, without limitation, the Manual in its entirety, financial information, marketing strategy, and programs are to be considered trade secrets of the franchisor

and shall be kept confidential and used by FRANCHISEE only in connection with the franchise operation. FRANCHISEE agrees not to divulge any of the trade secrets to any person other than its employees and then only to the extent necessary for the operation of the franchise and, specifically, that FRANCHISEE will not, nor permit anyone to, reproduce, copy, or exhibit any portion of the Manual or any other trade secrets of the franchisor. FRANCHISEE shall immediately notify franchisor of all infringements or limitations of franchisor’s marks, which come to its attention.

Figure 3.5 *Comparative Law: Intellectual Property Transfer Clause.*

entitled to establish individual franchise locations or to find sub-franchisees to operate within its territory. The contractual relationship may run between the sub-franchisee and the sub-franchisor or, most commonly, between the sub-franchisee and the franchisor. In fact, master franchise agreements are defined in the EU Franchise Regulations as those in which “the relationship between franchisor and franchisees is made through a third undertaking, the master franchisee.” In this way the franchisor can directly exercise control over the individual franchise operations.

The International Institute for the Unification of Private Law (UNIDROIT) has published an elaborate document titled *UNIDROIT Guide to International Master Franchise Arrangements*. It provides an array of information, along with standard clauses to be used in the drafting of a master franchise contract. The approach of the publication is to provide clauses that are fair to all parties concerned and are based on best practices. Some of the issues addressed include the types of franchising arrangements available, the relationship between the franchising agreement and other types of agreements (commercial agency, license, technology transfer, distribution), and the differences in the franchisor–franchisee and sub-franchisor–sub-franchisee relationships. The contract issues discussed include the nature and extent of the rights granted (e.g., exclusivity of rights granted to sub-franchisor); duration of agreement and provisions for renewal; alternative fee structures; calculation of payments (timing, accounting, currency, tax issues); costs and control of advertising; supply of equipment, products, and services; the transfer and protection of intellectual property (confidentiality clauses, noncompetition clauses, grant-back clauses, post-termination clauses); assignment and transfer; indemnification and insurance (franchisor liability to third parties); remedies for breach; and termination.

International Franchising

EU regulations define franchising as “a gathering of industrial or intellectual property rights relative to trademark, commercial denominations, insignia, utility models, designs, copyrights, know-how, or patents to be utilized for the resale of goods or services to a final user.”¹⁵ Under this definition, the franchisor sells to the franchisee the right to exploit a franchise and to commercialize specific goods or services. The franchise agreement generally requires a common and uniform presentation of franchise operations, the transfer of expertise and know-how from the franchisor to the franchisee, and the supplying of technical assistance by the franchisor. Principles recognized under U.S. franchise law do not always translate well into other legal systems, however. For example, the U.S. State Department’s Country Commercial Guide for Russia downplays the use of franchising as a viable option in entering the Russian market: “Franchising is little understood in Russia. Several early attempts to establish franchise distribution have foundered, due to confusion regarding ownership and the responsibilities of the parties to a franchise agreement.” However, the Guide qualifies the previous statement by noting that “some have been quite successful, and the potential remains quite high.” The court in *McAlpine v. AAMCO Automatic Transmission, Inc.*¹⁶ described the synergy of franchising and the inherent seeds for its own destruction:

The franchise arrangement starts as a mutually advantageous business relationship. Both the franchisor and the franchisee contribute to this arrangement in order to obtain benefits they could not obtain independently. The franchisor’s contribution is a combination of factors: trademark, recognized product or service, experience, advertising, and management support. The franchisee’s contribution is capital, day-to-day management and the payment of franchise fees. The franchisor benefits from the use of franchisee capital, fees, and lower-level management, for it allows the franchise organization to expand more rapidly. As the franchise becomes successful, the partnership arrangement, which seemed reasonable at its inception, and then begins to appear burdensome to the franchisee who comes to regard the payment of franchise fees as restricting its profitability.

To further illustrate the point, the *Dayan v. McDonald’s Corp.* case below exemplifies the two major risks of international franchising; namely, loss of control over franchise operations and the inability to terminate the franchise relationship.

Another issue especially important when franchising in a foreign country is to provide the appropriate means of termination and the protection of **trade secrets**. There is no generally accepted definition of trade secrets. It is a much broader concept than statutorily protected IPR (patent, copyright, trademark). The Uniform Trade Secrets Act offers this definition:

*“Trade Secret” means information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.*¹⁷

Raymond Dayan v. McDonald’s Corp.

466 N.E.2d 958 (Ill. App.1984)

This appeal arises out of a suit brought to enjoin McDonald’s Corporation from terminating Raymond Dayan’s restaurant franchise in Paris, France. Other issues relating to this controversy have been considered twice before by this court. After a 65-day trial, the circuit court of Cook County denied plaintiff’s request for a permanent injunction. The trial court issued a 114-page memorandum and an order terminating plaintiff’s franchise to operate McDonald’s restaurants in and around Paris.

This case has a lengthy legal and historical background involving prior litigation. Dayan originally filed an action against McDonald’s in 1970 alleging the defendant corporation had breached a prior agreement giving Dayan the right to purchase certain franchises and to develop and operate certain restaurants in Paris. The unique character of the 1971 license agreement was a key factor at trial. The record reveals that the terms of this agreement were the subject of extensive negotiations between McDonald’s and Dayan and differed substantially from McDonald’s standard licensing agreement. McDonald’s submitted three alternate proposals to Dayan. Proposal 1 was McDonald’s standard license agreement with a 3 percent royalty fee on gross receipts, real estate to be bought and developed by McDonald’s with rental rates comparable to U.S.A. leases. Proposal 2 was a joint venture with McDonald’s and Dayan each owning 50 percent equity. Proposal 3 was a developmental license similar to the original Canadian franchises and provided for a 1 percent royalty fee, Dayan to develop his own real estate, and no McDonald’s service except as ordered and paid for by Dayan. Under the standard McDonald’s license embodied in proposal 1, McDonald’s would be obligated to provide extensive services to Dayan in all areas of restaurant operations and Dayan would pay a correspondingly higher royalty fee. Dayan insisted upon the 1 percent developmental license.

The necessity of maintaining the Quality, Safety, and Cleanliness (QSC) standards is explicitly recognized in the Master License Agreement (MLA). It recites the rationale for maintaining QSC standards—“departure of Restaurants anywhere in the world from these standards impedes the successful operation of Restaurants throughout the world, and injures the value of its [McDonald’s] Patents, Trademarks, Trade name, and Property.” In addition, the individual operating license agreements (OLA) included the following termination provision:

Licensee acknowledges that uniform quality and taste of food, excellence of service, cleanliness, appearance, and general performance are of the utmost importance to the successful operation of the business venture of the Licensee and of all other Licensees using said System. The Licensee agrees that any violation of this paragraph shall be deemed to be a substantial breach of this Agreement and shall give the Licensor the right to terminate this Agreement.

Witnesses called by McDonald’s testified as to the deplorable condition of Dayan’s restaurants. In particular, their testimony revealed that Dayan was not using approved products; he used no pickles; he charged extra for catsup (ketchup) or mustard; he hid straws and napkins under the counter; he refused to take a refresher course at McDonald’s “Hamburger University”; the stores were filthy and without many items of necessary equipment; the store crews were poorly trained and frequently out of uniform; and customer complaints were numerous. Barnes, the president of McDonald’s international

division, testified that in June 1976 he informed Dayan that he would be given six months to bring his restaurants up to standard and at the end of this period McDonald's would exercise its right to formal inspection. The inspectors found gross violations of McDonald's QSC standards at all the stores they visited. In July 1977, a stern warning letter was sent to Dayan advising him that the number, variety, and severity of QSC deficiencies justified a default declaration but that such declaration would be held in abeyance for six months to "give you an opportunity to take immediate corrective action." Ultimately, McDonald's brought suit in Paris to terminate the MLA, which resulted in Dayan filing the present suit in Illinois to enjoin termination.

In Illinois, as in the majority of American jurisdictions, a *covenant of good faith and fair dealing* is implied in every contract absent express disavowal. Problems relating to good faith performance typically arise where one party to the contract is given broad discretion in performance. The dependent party must then rely on the party in control to exercise that discretion fairly. It remains to be seen, however, what limitation the implied covenant of good faith imposes on franchisor discretion in terminating a franchise agreement. A Utah Supreme Court held that the implied covenant of good faith limited the power of the franchisor to terminate a franchise agreement without good cause. The court stated that: "when parties enter into a contract of this character, and there is no express provision that it may be cancelled without cause, it seems fair and reasonable to assume that both parties entered into the arrangement in good faith, intending that if the service is performed in a satisfactory manner it will not be cancelled arbitrarily." These cases reflect judicial concern over longstanding abuses in franchise relationships, particularly contract provisions giving the franchisor broad unilateral powers of termination at will. Taken collectively, they stand for the proposition that the implied covenant of good faith restricts franchisor discretion in terminating a franchise agreement to those cases where good cause exists. However, plaintiff would have us go further and argues that even if McDonald's had good cause for termination, if it also had an improper motive, the termination would be a breach of the implied covenant of good faith. Dayan would attribute to McDonald's a desire to recapture the lucrative Paris market as an impermissible motive. We cannot agree. As a general proposition of law, it is widely held that where good cause exists, motive is immaterial to a determination of good faith performance.

Our review of the evidence admits of no doubt; the trial court properly resolved this issue in favor of McDonald's. To characterize the condition of Dayan's restaurants as

being in substantial noncompliance with McDonald's QSC standards is a profound understatement. Throughout the trial the various witnesses struggled to find the appropriate words to describe the ineffably unsanitary conditions observed in these restaurants, as did the trial court in its memorandum opinion. Terms describing the uncleanness—such as "indescribable," "extremely defective sanitary conditions," "filthy, grimy, cruddy," "deplorable," "significantly unsanitary," "contaminated," "unsanitary," "very dirty," "very, very dirty," "disgusting," "abundance of filth," "pig pens"—tell only part of the story. The accuracy of these epithets is supported by voluminous, detailed testimonial evidence, which consumed many weeks of trial and thousands of pages of transcript and is also corroborated by over 1,000 photographs admitted in evidence at trial. Dayan also argues that McDonald's was obligated to provide him with the operational assistance necessary to enable him to meet the QSC standards. As the trial court correctly realized: "It does not take a McDonald's trained French speaking operational man to know that grease dripping from the vents must be stopped and not merely collected in a cup hung from the ceiling, that dogs are not permitted to defecate where food is stored, that insecticide is not blended with chicken breeding, that past-dated products should be discarded, that a potato peeler should be somewhat cleaner than a tire-vulcanizer and that shortening should not look like crank case oil."

Contrary to plaintiff's contention, the MLA negotiated by him explicitly stated what he had to do if he wished such assistance; he had to request it in writing and pay for it. Accordingly, we reject Dayan's argument that he was entitled to the same operational assistance prior to termination as the standard licensee. The judgment of the trial court denying plaintiff's request for a permanent injunction and finding that McDonald's properly terminated the franchise agreement is **AFFIRMED**.

Case Highlights

- Note the length and complexity, and ultimately the costs, of the litigation pertaining to this termination of a franchise agreement.
- A master license agreement (MLA) is often used to develop an entire territory, while each franchise location is also governed by individual operating license agreements (OLA).
- Under U.S. law, the franchisor's right to terminate a franchise is limited by the duty of good faith and fair dealing, along with individual state statutes.
- Standards relating to quality, safety, and cleanliness (QSC) are vital to maintaining the integrity and reputation of the franchise system as a whole.

The franchisor should determine if the information being given is a trade secret. If so, it should expressly list in the franchise agreement the information that it intends to treat as trade secrets. The agreement may list information not generally considered trade secrets and expressly state that the information is to be deemed “secret and confidential.” For example, customer lists provided by the franchisor have been held to be legally protected trade secrets. A trade secret designation in the agreement is enhanced if: (1) the information is not readily obtainable through alternative sources and (2) the franchisor treats the lists as “secret and confidential.” The agreement can further protect the franchisor with a separate confidentiality clause and a noncompetition clause. The noncompetition clause should balance the goal of protecting the franchisor with the need to devise reasonable restrictions regarding scope, duration, and territory. Overly restrictive noncompetition clauses are likely to be reviewed and modified by most courts.

A franchise agreement that provides for a large amount of franchisor control may create problems under host country regulation. “Excessive control or the public appearance of such control may give rise to an agency relationship between the franchisor and the franchisee”¹⁸ under foreign law. If viewed as a dependent agency relationship, the franchisor may become susceptible to the tax and labor laws of the host country, as well as vulnerable to lawsuits such as products liability claims. The next section briefly reviews foreign regulation of franchising.

Foreign Regulation of Franchising

A number of restrictions on franchising can be found in U.S. and foreign laws. For example, in the United States a number of state franchise statutes limit the ability of the franchisor to terminate the franchise at will. Internationally, some countries offer a less friendly environment for franchising than is found in the United States. Host country laws vary significantly—from laws that do not even recognize the franchise form of business to laws that limit the types of contract provisions that will be enforced. The effectiveness of using model forms is limited by the fact that vast differences in contractual issues occur from industry to industry and under host country laws. The next subsection will review EU Franchise Regulations for purposes of negotiating legally enforceable franchise agreements. The Regulations offer insight about what types of clauses can be incorporated into an international franchise agreement.

EU Franchise Regulations

The EU places limits on franchises in order for them to conform to its competition law. The **EU Regulations of Franchise Agreements** provides an exemption from the application of EU competition law found in Article 85 of the Treaty of Rome.¹⁹ However, it is also an indispensable source to be used in the drafting of a franchise agreement. Commission Regulation 4087/88 pertains to franchise agreements involving the distribution of goods or services, along with master franchise agreements. The Regulation expressly exempts from its coverage industrial franchises that generally include the manufacture of products through the transfer of IPR. It notes that those types of franchises may make use of the block exemptions pertaining to patent and know-how licensing. EU Regulations in those areas will be discussed in Chapter 18, “Law of Intellectual Property Rights,” and Chapter 19, “Intellectual Property Licensing.”

The EU Regulations recognize that some restrictions on the rights of the franchisee are needed in order to maintain the “homogeneity of the network and the constant cooperation between the franchisor and the franchisees [in order to] ensure a constant quality of the products and services” being provided. Article 2 provides a list of clauses that, although restrictive of competition, have a strong nexus to the above philosophical goals. They allow for the development of exclusive franchise territories and prohibit actively seeking customers outside the franchise territory.

Along those lines, a master franchisee can be prohibited from entering a sub-franchise agreement with an entity outside the territory of the master franchise. The agreement may also prohibit the franchisee from selling the goods or services of a competitor. The franchisor may insert clauses mandating that the franchisee only sell goods or services that match “minimum objective quality specifications.” Generally, the franchisee cannot be restricted in

determining its sources of supply. However, an exemption from this prohibition is given if requirements to purchase supplies from the franchisor or other designated third-party suppliers are necessary in order to meet “objective quality specifications.”

Other clauses that are expressly permitted include best efforts, minimum sales quotas, customer service and warranty requirements, advertising requirements, confidentiality (including post-termination confidentiality), training requirements, rights to improvements to franchisor’s intellectual property, location restrictions, non-assignment without prior consent, notice of infringement, and sales restricted to end users, other franchisees, and resellers.

Prohibited clauses include those that restrict a franchisee from purchasing from another franchisee, from filling orders from parties outside its territory that were not actively sought, unduly limiting the franchisee’s choice of suppliers or customers, and restrictions on pricing. These prohibited restrictions relate to a stated purpose of the Regulation that ensures that “parallel imports and cross deliveries between franchisees remain possible.” In the event that a contract clause restriction does not come within one of the “approved restrictions enumerated in the Regulation, then the parties will have to *notify* the European Commission for an approval or negative clearance.”

Chapter Summary

- 1 There are numerous methods or strategies of doing business in foreign countries, some more risky and costly than others. Common methods used to gain a presence in a foreign country include opening a branch office, joint venturing with another company, or establishing a separate foreign subsidiary company (Corporation, Limited Liability Company, or Benefit Corporation).
- 2 Foreign corporation law may be different than what is found in the United States. American corporation law focuses on the role of the shareholder, while in other countries corporate law sees shareholders and employees as equal stakeholders and, therefore, provide a wide array of employee protections. German corporations have two boards, the top board being the Supervisory Board with one-half of the members elected by shareholders and one-half by employees. The lower board is called the Management Board.
- 3 Some countries have entities that are not found in the United States, such as the joint stock company.
- 4 Other countries are often more willing to “pierce the corporate veil” and hold shareholders liable for corporate debt than is found under American law.
- 5 European competition (antitrust) law is in certain areas stricter and places greater weight on consumer benefit than is found in the United States. Before buying or merging with a European company, a company should seek the clearance or approval of Directorate IV of the European Commission.
- 6 Joint ventures are a common means of expanding into foreign markets. In the common scenario, a company outside of a country partners with a company inside the country. This allows the outside company the ability to use the existing distribution network, knowledge of the foreign law, and government connections of its partner.
- 7 The key document in joint venturing is the joint venture agreement. This contract should be carefully negotiated and drafted. It is important that the joint venture agreement be strategic in nature in order to increase the chances of the joint venture being successful. Some of the important clauses in an international joint venture agreement include: purpose, exception, and cross-indemnity clauses.
- 8 The joint venture agreement is generally accompanied by a number of ancillary contracts, such as distribution, intellectual property or licensing, and secondment contracts.
- 9 Some countries, such as China, have specific laws that regulate joint ventures or certain types of ventures, such as technology joint ventures.
- 10 Franchising has become a method of quickly expanding overseas through direct, master, regional development, and distribution franchise arrangements. Franchising benefits from a block exemption under EU competition law.
- 11 A substantial body of franchise law has developed in the United States and has begun to evolve in other countries, such as countries in Europe and in China.

- 12 Some of the key clauses in the franchise agreement include: site selection, operational standards, territorial, royalties, intellectual property transfer, and renewal clauses. However, certain versions of some of these clauses may be unenforceable under EU Franchise Regulations.

Key Terms

Affiliate	Export Trade Certificate of Review	Piercing the Corporate Veil
Benefit Corporation	Foreign Subsidiary	Purpose Clause
Block Exemption	Franchisee Review Clause	Renewal Clause
Branch Office	General Partnership	Representative Office
Business Review Letter	Insurance Clause	Royalties Clause
Competition Law	Intellectual Property Transfer	Secondment Agreement
Contractual Joint Venture Corporation	Joint Stock Company	Shareholders' Council
Counter-Indemnity Clause	Joint Venture	Site Selection Clause
Crowdfunding	Limited Liability Company (LLC)	Social Enterprise Company
Distribution Agreement	Limited Partnership	Social Entrepreneurship
Enterprise Liability	Management Agreements	Supervisory Board
Equity Joint Venture	Management Board	Supervisory Committee
EU Regulations of Franchise Agreements	Master Franchise	Territorial Clause
Exceptions Clause	Operational Standards Clause	Trade Secrets
		Transfer Pricing

Chapter Problems

- Read the following articles and do a comparative analysis: Ronald J. Gilson and Mark J. Roe, "Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance," 99 *Columbia Law Review* 508 (1999); Mark J. Roe, "German Codetermination and German Securities Markets," 1998 *Columbia Business Law Review* 167 (2011); Mark J. Roe, "Some Differences in Corporate Structure in Germany, Japan, and the United States," 102 *Yale Law Journal* 1927 (1993).
- Select two of the following countries: China, United States, Japan, Germany. Compare and contrast corporate law in the two countries you have selected. Discuss how corporate law reflects society's fundamental view of the role of the corporation.
- What does the phrase "piercing the corporate veil" mean? When might the corporate veil be pierced? How does this philosophy compare with that of many of the United States' trading partners?
- What are some of the issues that potential joint venture partners need to discuss in detail before entering into an agreement? Discuss some of the contractual clauses that can be incorporated into an agreement in order to minimize potential conflict.

Internet Exercises

- Research a foreign country or countries for opportunities and restrictions on the different ways of transacting business discussed in this chapter using the U.S. Department of State's Country Commercial Guides. Individual Country Commercial Guides can be obtained at <http://www.state.gov>.
- Research the status of franchising in a foreign country. A good place to start is the web site for the International Franchise Association at <http://www.franchise.org>. A growing number of national franchise associations, along with the European Franchise Federation, can also be assessed.

Other Internet Sources

Cornell Legal Information Institute at <http://www.law.cornell.edu/topics/corporations.html> (overview of corporation law).

UNIDROIT Guide to International Master Franchise Arrangements (2nd ed. 2007): <http://www.unidroit.org/instruments/franchising/guide/second-edition-2007>.

International Franchise Association: <http://www.franchise.org>.

Notes

- 1 *Microbanking Bulletin*, December 2009 (Issue No. 19).
- 2 See <http://www.grameenfoundation.org/our-impact/personal-stories>.
- 3 Excerpted from Timothy L. Fort and Cindy A. Schipani, "Corporate Governance in a Global Environment: The Search for the Best of All Worlds," 33 *Vanderbilt Journal of Transnational Law* 829 (2000).
- 4 699 N.Y.S.2d 503 (1999).
- 5 See Edward C. Vandenberg, "The Evolution of Russian Forms of Business Enterprise," 28 *Ottawa Law Review* 343 (1997).
- 6 See generally Karen J. Hladik, *International Joint Ventures* (1985).
- 7 William F. Fox, Jr., *International Commercial Agreements: A Primer on Drafting, Negotiating and Resolving Disputes* 79 (1992).
- 8 Denis Philippe, "Drawing Up a Joint Venture Contract," 20 *The Comparative Law Yearbook of International Business* 25, 27 (1998).
- 9 Mark Pery-Knox-Gore, "Joint Ventures" in *Structuring International Contracts* 87 (ed. Dennis Campbell 1997).
- 10 Steven R. Salbu and Richard A. Brahm, "Strategic Considerations in Designing Joint Venture Contracts," *Columbia Business Law Review* 253 (1992).
- 11 William G. Frenkel, "Legal Protection against Risks Involved in Doing Business in the Republics of the Former U.S.S.R.," 10 *International Quarterly* 395, 467 (1998).
- 12 Robert W. Emerson, "Franchise Contract Clauses and the Franchisor's Duty of Care Toward its Franchisees," 72 *North Carolina Law Review* 905, 909 (1994) (the article is the source of much of the material covered in this section).
- 13 929 F.2d 801 (S.D. Fla. 1992).
- 14 See Robert W. Emerson, "Franchising and the Collective Rights of Franchisees," 43 *Vanderbilt Law Review* 1503, 1511, n. 27 (1990).
- 15 Regulation EEC 4087/88.
- 16 461 F. Supp. 1232, 1238-39 (E.D. Mich. 1978).
- 17 Uniform Trade Secrets Act § 1(4), 14 U.L.A. 541 (1980).
- 18 Ralph H. Folsom and Michael W. Gordon, *International Business Transactions* 428 (1995).
- 19 Commission Regulation (EEC) No. 4087/88 of 30 November 1988 on the Application of Article 85(3) of the Treaty to Categories of Franchise Agreements.

INTERNATIONAL COMMERCIAL DISPUTE RESOLUTION

The cost and uncertainty of potential litigation with a foreign citizen or company can act as a deterrent to entering into an international business transaction. The prospect of having to pursue or defend a claim in a foreign court using foreign law may prove too risky for some businesspersons. At the least, anyone contemplating a business transaction with a foreign entity should ask the following questions: (1) What are the alternatives to transnational litigation? (2) Where will a future dispute be argued or settled? (3) What country's law would be applied to such a dispute? (4) Will a settlement or decision be enforceable in a foreign country? These questions should be discussed during the earlier stages of contract negotiation, and an international contract should expressly answer these questions through the use of forum selection, choice of law, and alternative dispute resolution clauses. The answer to question (1) is that international commercial arbitration is a popular alternative to international litigation. The contractual devices represented by choice of law and forum selection clauses provide the avenue for dealing with questions (2) and (3). Finally, a review of national laws and international conventions will help answer question (4).

International Litigation

Anyone seeking to undertake international litigation faces three areas of concern. First, how does one properly begin a lawsuit against a foreign company? Second, once the litigation begins, how do the parties gather evidence in foreign countries? Third, if successful in the litigation, how does one enforce a judgment in a foreign country?

Starting Litigation: Service of Process and Jurisdiction

To bring a lawsuit against a foreign company, one must properly serve process. **Service of process** is the formal notification for a defendant to defend himself in court. Proper service of process is necessary in order for a court to obtain **personal jurisdiction** over the defendant. Failure to obtain legally sufficient service of process is likely to result in the nonenforceability of any *default judgment* obtained in the event that the defendant fails to appear. In order to require a foreign party to defend itself in a suit brought in the United States, the service of process should meet the requirements of both the United States and the country of the party being served. This is especially crucial if the judgment will need to be enforced in a foreign country. Service of process requirements vary widely throughout the world. The United States Federal Rules of Civil Procedure state that service in a foreign country may be made "by any form of mail, requiring a signed receipt, to be addressed and dispatched by the clerk of the court to the party to be served." In contrast, service by mail is generally not recognized by foreign court systems.

Adoption of the Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters, or **Hague Service Convention**, is one response to the problem of international service of process. The Hague Service Convention provides a government means to ensure effective and recognizable service of process. The signatory countries to the Convention are required to establish a Central Authority for processing foreign plaintiffs' service of process requests. The Central Authority serves the defendant directly or arranges to have it served by the appropriate government agency. Although many countries have not adopted the Hague

Service Convention, a number of important trading countries have adopted it, including the United States, Japan, China, France, Germany, Great Britain, Italy, Spain, and Canada. In countries not party to the Convention, **dual service** of process is recommended. Dual service aims to satisfy the service requirements of the country of the forum court and the country of the defendant in order to enhance the enforceability of any future judgment. The issues of personal jurisdiction over a foreign defendant are discussed in *Alpine View Co., Ltd. v. Atlas Copco AB*.

Alpine View Co., Ltd. v. Atlas Copco AB

205 F.3d 208 (5th Cir. 2000)

King, Chief Judge. This case arises out of an alleged breach of a 1992 Intentional Agreement (1992 Agreement) between Alpine View Company, Limited (Alpine View), and Uniroc AB (Uniroc), a wholly-owned subsidiary of a Swedish holding company, and Atlas Copco AB (ACAB). In 1989, Bjorn Hansen, the president of Alpine View, was granted exclusive worldwide rights to the distribution and sale of offshore drill bits manufactured by Shanghai Machinery & Equipment Import-Export Corporation (SMEC), a Chinese company.

To facilitate the sale of these products, Hansen sought an established distributor, and eventually executed the 1992 Agreement with Uniroc. Under the 1992 Agreement, Uniroc was to purchase drill bits from Bjorn Hansen, and eventually become the exclusive distributor of the products in certain specified sectors of the world market. Uniroc was to pay Alpine View a commission based on net sales to users and distributors outside the Atlas Copco Group, which comprises ACAB and its 71 subsidiaries. To enhance its ability to deal directly with SMEC, Uniroc entered into a separate distributorship agreement with that company. The existence of the separate distributorship agreement was a precondition for the effectiveness of the 1992 Agreement. Alpine View is incorporated under the laws of the British Virgin Islands and Hansen is a resident of Norway. Compressors and Comptec are each Delaware corporations, with Compressors having its principal place of business in Massachusetts and Comptec having its in New York. Robbins is a Washington corporation and has its principal place of business in that state. Compressors, Comptec, and Robbins are all subsidiaries of ACAB.

Dismissal for Lack of Personal Jurisdiction

We review the district court's dismissal for want of personal jurisdiction. The Due Process Clause permits the exercise of personal jurisdiction over a nonresident defendant when (1) that defendant has purposefully availed himself of the

benefits and protections of the forum state by establishing *minimum contacts* with the forum state; and (2) the exercise of jurisdiction over that defendant does not offend traditional notions of fair play and substantial justice. Minimum contacts can be established either through contacts sufficient to assert specific jurisdiction, or contacts sufficient to assert general jurisdiction. *Specific jurisdiction* over a nonresident corporation is appropriate when that corporation has purposefully directed its activities at the forum state and the "litigation results from alleged injuries that arise out of or relate to those activities." *General jurisdiction*, on the other hand, will attach where the nonresident defendant's contacts with the forum state, although not related to the plaintiff's cause of action, are "continuous and systematic."

1. Specific Jurisdiction and Stream-of-Commerce Theory

The Supreme Court stated that the "foreseeability that is critical to due process analysis is that the defendant's conduct and connection with the forum State are such that he should reasonably anticipate being hauled into court there." Appellants rely heavily on the stream-of-commerce theory. In support of their argument that the *stream-of-commerce theory* is applicable to cases other than those involving products liability, Appellants point to courts applying the theory to cases raising antitrust or intellectual property related claims. When a nonresident's contact with the forum state stems from a product, sold or manufactured by the foreign defendant, which has caused harm in the forum state, the court has specific jurisdiction if it finds that the defendant delivered the product into the stream of commerce with the expectation that it would be purchased by or used by consumers in the forum state. However, delivery of products into the stream of commerce does not support assertion of specific jurisdiction over ACAB and Robbins. Appellants argue that putting products into the stream of commerce with the

expectation that Texans will purchase or use those products suffices to establish jurisdiction with respect to “any claims.” This is more akin to a general jurisdiction argument than to a specific jurisdiction argument. Appellants make no attempt to link Appellees’ contacts with Texas and the instant litigation. This is a link that specific jurisdiction requires. Appellants have not asserted that the alleged misdeeds occurred in Texas, or that the 1992 Agreement was negotiated or executed in Texas. Neither Alpine View nor Hansen is considered a Texas resident.

2. General Jurisdiction and Alter-Ego Theory

Appellants also challenge the district court’s conclusion that they had not shown that assertion of general jurisdiction was proper in this case. To make a *prima facie* showing of general jurisdiction, Appellants must produce evidence that affirmatively shows that ACAB’s and Robbins’ contacts with Texas that are unrelated to the litigation, are sufficient to satisfy due process requirements. Those unrelated contacts must be substantial, continuous, and systematic. Examining the submitted evidence, it is clear that Appellants have not demonstrated that Robbins’ direct contacts with Texas during the relevant period were sufficient to establish general jurisdiction. The evidence shows, at best, that Robbins sold, on isolated occasions, products to entities located in Texas and that Robbins’ personnel made field service visits to Texas. These contacts are neither substantial, continuous, nor systematic.

The same conclusion is compelled with regard to ACAB. Appellants rely on evidence that indicates that the products of ACAB’s subsidiaries are sold in Texas. However, “a foreign parent corporation is not subject to the jurisdiction of a forum state merely because its subsidiary is present or doing business there; the mere existence of a parent-subsidiary relationship is not sufficient to warrant the assertion of jurisdiction over the foreign parent.” Appellants must make a *prima facie* showing that ACAB so controls other organizations that the activities of those organizations may be fairly attributed to ACAB for purposes of asserting jurisdiction over it. Under Texas law, the *alter-ego doctrine* applies when there is such unity between the parent corporation and its

subsidiary that the separateness of the two corporations has ceased and holding only the subsidiary corporation liable would result in injustice. We have said, however, that “100% stock ownership and commonality of officers and directors are not alone sufficient to establish an *alter-ego* relationship between two corporations.” Instead, “the degree of control exercised by the parent must be greater than that normally associated with common ownership and directorship.” Such control has not been indicated here. The existence of inter-corporate loans does not establish the requisite dominance, and in fact, interest-bearing loans suggest separation of corporate entities. We conclude that the district court did not err in dismissing Appellants’ claims against Robbins and ACAB for lack of personal jurisdiction.

Case Highlights

- International litigation is often complex due to the diversity of the parties. In this case, the parties were from China, Sweden, Norway, the British Virgin Islands, and the states of New York, Massachusetts, Washington, and Delaware.
- The due process clause of the U.S. Constitution requires that personal jurisdiction over a defendant must be based on either “minimum contacts” for purposes of gaining specific jurisdiction or “substantial, continuous, and systematic” contacts for purposes of gaining general jurisdiction.
- Specific jurisdiction requires a nexus between the minimum contacts and the injuries claimed, while general jurisdiction allows for lawsuits on even unrelated claims.
- The “stream-of-commerce” theory is only applicable if the defendant delivers a product into the stream of commerce with the expectation that it would be purchased in the forum state.
- A foreign parent company does not become subject to the jurisdiction of a foreign court simply because its subsidiary is amenable to that state’s jurisdiction.
- “Alter ego-theory” allows for jurisdiction over a parent company if the parent company “dominates” the activities of a subsidiary that has sufficient contacts with the forum court.

Litigation Defenses: Immunity of Foreign Governments and Officials

There are a number of defenses to a foreign court’s exercise of jurisdiction even when such an exercise would be proper under the requirements of due process. **Sovereign immunity** prevents a sovereign state or person from being subjected to suit without its consent. The **doctrine of sovereign immunity** stands for the principle that a nation is

immune from suit in the courts of another country. The U.S. Supreme Court recognized sovereign immunity in the 1812 case of *The Schooner Exchange v. M'Faddon*.¹ The U.S. Department of State was entrusted with the right to grant requests of immunity for foreign officials. The Foreign Sovereign Immunities Act (FSIA) was enacted in 1976. The FSIA recognized an important exception of foreign immunity called the commercial activities exception. Foreign sovereign immunity does not extend to foreign governments immunity when they engage in commercial activities, such as procuring goods and services from private companies. The FSIA also granted the exclusive power to decide sovereign immunity issues to the courts, rather than to the State Department.

The *Central Bank of the Philippines v. Ferdinand E. Marcos* case introduces the nondiscretionary **defenses of foreign sovereign immunity, head-of-state immunity, and diplomatic immunity**. These defenses to jurisdiction are limited to lawsuits involving a foreign country and its officers.

Central Bank of the Philippines v. Ferdinand E. Marcos

665 F. Supp. 793 (N.D. Cal. 1987)

Orrick, District Judge. Ferdinand Marcos, former President of the Republic of the Philippines, is presently involved in a lawsuit in the United States District Court of Hawaii. The Central Bank of the Philippines brought suit in the U.S. District Court of Hawaii against former President Marcos seeking the return of certain gold and currency. In the course of discovery, Marcos served a subpoena on Philippine Solicitor General Ordonez, during a recent visit of his to San Francisco to appear for a deposition. The U.S. filed the present motion to quash the subpoena on the grounds that Ordonez was entitled to immunity. The U.S. Department of State government relies primarily upon the doctrine of foreign sovereign immunity, and the “head-of-state” immunity on behalf of Ordonez.

Foreign Sovereign Immunity

First, the Foreign Sovereign Immunities Act (FSIA) has abrogated the binding nature of “Suggestion of Immunity” issued by the State Department. The FSIA sets forth comprehensive standards for determining when a foreign state is entitled to immunity. Second, the sovereign immunity doctrine may not serve as a basis for Ordonez’ immunity in this instance because it is not applicable to individual government officials. The FSIA provides that a “foreign state shall be immune from the jurisdiction of the courts of the United States” with certain exceptions.

Head-of-State Immunity

The government also argues that Ordonez is entitled to head-of-state immunity, despite the fact that he is neither a sovereign nor a foreign minister, the two traditional bases for a recognition or grant of head-of-state immunity. In fact, the government in this instance seeks to expand the head-of-state doctrine to encompass all government officials of a foreign state. There is no precedent for such a radical departure from past custom.

Diplomatic Immunity

The final potential ground for recognition of the immunity of Ordonez is found in the doctrine of “diplomatic immunity.” There is a rich jurisprudential and statutory history surrounding the international practice of diplomatic immunity. The Diplomatic Relations Act of 1978 established the Vienna Convention on Diplomatic Immunity as the sole United States law on the subject. Article 31 of the Convention provides that, with certain exceptions, a diplomatic agent shall be immune from the civil jurisdiction of the “receiving” state’s courts, and shall “not be obliged to give evidence as a witness.”

Marcos has argued that any immunity in the Philippines’ diplomatic agents has been waived by the institution of this lawsuit by the Central Bank of the Philippines. A sending state does not waive any and all diplomatic immunity for its agents merely through the institution of a suit. Unlike sovereign immunity, whether a diplomatic agent is entitled to diplomatic immunity is a matter for the State Department. Out of respect for the foreign policy decisions of the Executive Branch, this Court finds that Ordonez is entitled to diplomatic immunity.

Case Highlights

- A grant of diplomatic immunity is considered a discretionary decision of the executive branch through certification by the Department of State.
- Foreign sovereign immunity, as provided for under the FSIA, is reserved for foreign states and the agencies or instrumentalities of a foreign state.
- Head-of-state immunity is limited to top-level officials and does not apply to all foreign government officials or employees.

The courts have also developed a general discretionary principle known as the *forum non conveniens* doctrine. *Forum non conveniens* doctrine is Latin for “a forum, which is not convenient.” It can be applied to any case if the court determines that **there is another more convenient forum to hear the case**. This doctrine is employed when the court chosen by the plaintiff (the party suing) is inconvenient for witnesses or poses an undue hardship on the defendants. In such situations, the defendants would petition the court for an order dismissing the case or transferring it to a more convenient court. The *Capital Currency Exchange v. National Westminster Bank* case examines some of the nuances of this judge-made doctrine.

Capital Currency Exchange v. National Westminster Bank

155 F.3d 603 (2d Cir. 1998)

McLaughlin, Circuit Judge. Capital Currency Exchange, N.V. (CCE), is a financial company organized under the laws of the Netherlands Antilles. CCE and its affiliates are engaged principally in two kinds of international financial transactions: (1) retail currency exchange and (2) money transfers from the United States to England. CCE and its affiliates had a longstanding banking relationship with Barclays UK. In 1991, CCE, on behalf of Worldcash, sought a New York State money transmission license. To qualify for this license, Worldcash had to post a \$500,000 bond in favor of the New York State banking authorities. CCE arranged with Barclays UK’s New York office to issue an irrevocable letter of credit as security for the bond. In May 1995, for reasons that the parties dispute, Barclays UK told CCE to find another banker. In August 1995, NatWest UK declined to provide CCE with banking services. CCE maintains that NatWest UK and Barclays UK conspired to drive CCE out of the money transfer business by depriving it of banking services in violation of the antitrust laws, specifically Sections 1 and 2 of the Sherman Act. On November 6, 1996, defendants moved to dismiss the complaint under the *forum non conveniens* doctrine.

In a *forum non conveniens* analysis, a court must determine that an adequate alternative forum exists. An alternative forum is adequate if: (1) the defendants are subject to service of process there; and (2) the forum permits “litigation of the subject matter of the dispute.” We believe there is an adequate, alternative forum. Plaintiffs may challenge defendants’ allegedly anticompetitive actions under Articles 85 and 86 of the Treaty of Rome, which English courts are bound to enforce. Although English courts have not yet awarded damages in an antitrust case, it appears that English courts have the power to do so. It is well established, however, that the unavailability of treble damages does not render a forum inadequate. Thus, suits brought under the Sherman Act are subject to dismissal under the *forum non conveniens* doctrine.

AFFIRMED.

Case Highlights

- In order for a court to dismiss a case under the *forum non conveniens* doctrine, it must determine that an adequate alternative forum exists.
- The unavailability of certain remedies under the laws of the alternative forum does not render that forum inadequate.

The doctrine of sovereign immunity protects foreign governments only from essentially governmental activities and not from *commercial* activities. The problem with this type of categorization of activities is that government procurement has become increasingly commercialized, making the distinction between sovereign and commercial activities difficult to define. The gravity of this problem becomes apparent in developing countries where almost by necessity a governmental entity is involved with international transactions. For example, a government partner is common in joint venture undertakings in developing countries. It is important in such dealings to negotiate a contract clause in which the governmental entity *waives* its potential sovereign immunities and **Act of State**² defenses. The Supreme Court limited the reach of *foreign official immunity* under the FSIA in *Samantar v. Yousuf*.

Samantar v. Yousuf

(130 S. Ct. 2278 2010)

Justice Stevens. Respondents, who were persecuted by the Somali government during the 1980s, filed a damages action alleging that petitioner, who then held high level

government positions, exercised command and control over the military forces committing the abuses. The District Court concluded that it lacked subject-matter jurisdiction

and granted petitioner's motion to dismiss the suit, resting its decision on the Foreign Sovereign Immunities Act of 1976 (FSIA). The Fourth Circuit reversed, holding that the FSIA does not apply to officials of a foreign state.

Under the common-law doctrine of foreign sovereign immunity, if the State Department granted a sovereign's diplomatic request for a "suggestion of immunity," the district court surrendered its jurisdiction. If the State Department refused, the court could decide the immunity issue itself. In 1952, the State Department moved from a policy of requesting immunity in most actions against friendly sovereigns to a "restrictive" theory that confined immunity "to suits involving the foreign sovereign's public acts." Inconsistent application of sovereign immunity followed, leading to the FSIA, whose primary purposes are (1) to endorse and codify the restrictive theory, and (2) to transfer primary responsibility for deciding "claims of foreign states to immunity" to the courts. This Act now governs the determination whether a foreign state is entitled to sovereign immunity.

Reading the FSIA as a whole, there is nothing to suggest that "foreign state" should be read to include an official acting on behalf of that state. The Act specifies that a foreign state "includes a political subdivision or an agency or instrumentality" of that state. "Entity" typically refers to an organization. The list set out there, even if illustrative rather than exclusive, does not suggest that officials are included, since the listed defendants are all entities.

The FSIA's history and purposes also do not support petitioner's argument that the Act governs his immunity claim. State and official immunities may not be coextensive.

Though a foreign state's immunity may, in some circumstances, extend to an individual for official acts, it does not follow that Congress intended to codify that immunity in the FSIA. In this case, respondents have sued petitioner in his personal capacity and seek damages from his own pockets, is governed by the common law because it is not a claim against a foreign state as defined by the FSIA. The court noted only that the district court had rejected the argument that petitioner had necessarily acted beyond the scope of his official authority by allegedly violating international law.

Therefore, the FSIA does not govern petitioner's claim of immunity.

AFFIRMED.

Case Highlights

- FSIA provides immunity from litigation against foreign countries in American courts.
- The FSIA restricted the immunity to suits involving the foreign sovereign's "public acts" and transferred the power to grant the immunity from the U.S. State Department to the courts.
- The immunity does not automatically attach to foreign government officials. It does not apply in this case because the former official is being sued in his personal capacity and the plaintiff is seeking damages from the official and not the foreign government.
- The FSIA does not apply to a foreign government official acting beyond the scope of his official authority in violation of international law.

While it is now settled that an individual sued for conduct undertaken in his or her official capacity cannot claim the benefits of the FSIA, the decision did not finally resolve the question of the petitioner's own amenability to suit.³ The case was therefore remanded to determine whether the petitioner is entitled to immunity under federal common law. International immunities can no longer be considered merely a question of grace, comity, or convenience but must be grounded in a clear relationship to customary international law.

That traditional method has been followed in most cases involving head-of-state and head-of-government immunity, and more recently in the case of special diplomatic mission immunity, where the applicable principles are similarly derived from customary international law.

Human rights advocates might generally be pleased that individual officials can no longer claim immunity under the FSIA. The next section examines the **Alien Tort Claims Act (ATCA)** that provides standing to sue in U.S. courts to foreign parties and for torts committed outside the U.S. in certain situations.

Alien Tort Claims Act

The ATCA is an old U.S. law enacted in 1789 that states that: "The U.S. district courts shall have original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States." From 1789 to 1980, only two courts heard cases based on the jurisdiction granted by the ATCA. The unanswered question was what was the extraterritorial nature and extent of the ATCA. Part of the answer came in

the 1980 landmark case of *Filártiga v. Peña-Irala*,⁴ where the Second Circuit Court of Appeals held that the ATCA granted jurisdiction against non-American citizens for tort acts committed outside the U.S. where there is a violation of public international law or any treaties to which the U.S. is a party. The case involved two Paraguayan citizens residing in the U.S. who brought suit against a Paraguayan former police chief who was also living in the United States, alleging that the defendant had tortured and murdered a member of their family. The court ruled in favor of the plaintiffs, awarding them \$10.4 million. The court reasoned that torture was clearly a violation of the law of nations, and the United States did have jurisdiction over the case since the claim was lodged when both parties were inside the United States.

Since the *Filártiga* decision, numerous suits have been brought under the ATCA for human rights abuses, including cases brought against private corporations as “aiding and abetting” foreign governments in committing human rights violations.

Other than its resurrection as a means of prosecuting human rights violators, it is clear that the ATCA extends to American companies that commit tort acts outside the U.S. Since 1980, courts have interpreted this statute to allow foreign citizens to seek remedies in U.S. courts for human rights violations and torts committed outside the United States. In 2013, the U.S. Supreme Court, in *Kiobel v. Royal Dutch Petroleum Co.*, had to decide the issue of whether persons legally in the U.S. could bring a tort action in the U.S. courts against foreign companies for torts committed in Nigeria.⁵ The only other recent Supreme Court decision was the 2004 case of *Sosa v. Alvarez-Machain*.⁶ In that case, a Mexican citizen accused of killing a U.S. DEA agent in Mexico was kidnapped by Mexican nationals hired by the DEA and brought to the U.S., where he was acquitted due to a lack of evidence. He brought suit against the U.S. government under the ATCA. The Supreme Court unanimously ruled that the ATCA was intended only to give courts jurisdiction over those violations accepted by the civilized world in the eighteenth century, such as piracy and safe conduct of ambassadors. Because the claimant did not fall into one of these traditional categories, he had no standing under the ATCA. In a ruling that is likely to result in a significant reduction in international human rights litigation in U.S. courts, the Court in *Kiobel v. Royal Dutch Petroleum Co.* invoked the “presumption against extraterritoriality.”

Kiobel v. Royal Dutch Petroleum Co.

133 Sup. Ct. 1659 (2013)

Twelve Nigerian citizens obtained political asylum in the United States and then sued Dutch and British oil companies. The plaintiffs alleged that the defendants, through their Nigerian subsidiary, had aided and abetted human rights violations including forced exile and murder. In cooperation between the defendants and the Nigerian military, a peaceful resistance to oil development in the Ogoni Niger River Delta was violently crushed. The claimants assert that the defendants provided transportation to Nigerian forces; allowed their property to be utilized as a staging ground for attacks; provided food for soldiers involved in the attacks; and provided compensation to those soldiers. The U.S. Court of Appeals (Second Circuit) held broadly that private corporations could not be sued under the U.S. Alien Tort Claims Act (ATCA).

Chief Justice Roberts. The Supreme Court unanimously affirms the Second Circuit’s dismissal, but disagreed about the reason. The majority opinion was joined by three concurring opinions. Applying the “presumption against extraterritoriality” serves to protect

against unintended clashes between our laws and those of other nations, which could result in international discord.

The Court acknowledges that the ATCA is potentially distinguishable from statutes like the Securities Exchange Act, in that the ATCA is “strictly jurisdictional.” But the majority held that “the principles underlying the presumption against extraterritoriality constrain courts considering causes of action that may be brought under the ATCA.” Indeed, the danger of unwarranted judicial interference in the context of foreign policy is magnified in the context of the ATCA, because the question is not what Congress has done but instead what courts may do. The mere fact that the ATCA refers to suits by aliens for torts in violations of international law does not imply an extraterritorial reach, since such torts could occur “either within or outside the United States.” Nor does the transitory tort doctrine support extraterritorial application of the ATCA, said the Court, because that doctrine involves the application of foreign tort law, whereas ATCA cases involve the development of causes of action under U.S. law.

ATCA was designed to help the United States avoid foreign relations friction, such as by ensuring an avenue of redress for foreign officials injured within this country. The Court expressed concern that applying the ATCA to foreign conduct has the potential to exacerbate rather than alleviate friction with foreign countries.

On these facts, all the relevant conduct took place outside the United States. And even where the claims touch and concern the territory of the United States, they must do so with sufficient force to displace the presumption against extraterritorial application. Corporations are often present in many countries, and it would reach too far to say that mere corporate presence suffices.

Justice Kennedy, concurring. The opinion for the Court is careful to leave open a number of significant questions regarding the reach and interpretation of the Alien Tort Statute. In my view that is a proper disposition. Congress has addressed many serious concerns with respect to human rights abuses committed abroad in statutes such as the Torture Victim Protection Act of 1991.⁷

Justice Breyer, concurring and joined by Justices Ginsburg, Sotomayor, and Kagan. Instead of applying the presumption against extraterritoriality, the Court should limit ATCA litigation to three circumstances: (1) the alleged tort occurs on American soil, (2) the defendant is an American national, or (3) the defendant's conduct substantially and adversely affects an important American

national interest, including a safe harbor for a torturer or other common enemy of mankind. Breyer noted that that piracy was one of the tort claims that historically brought under the ATCA involved conduct not only outside the U.S. but also on foreign-flagged vessels that are effectively like foreign territory. Nevertheless, the court agreed that this particular case should be dismissed given the defendants' minimal and indirect American presence.

Case Highlights

- The ATCA does not extend jurisdiction to foreign parties wanting to bring suit against a foreign corporation unless there is a close connection to American territory.
- This decision of the Supreme Court is interesting because it was a unanimous decision, but the reasons for the decision were varied among the majority opinion and three concurring opinions.
- The majority opinion rested on the presumption against the extraterritorial application of American law. The concurring opinion of four justices rejected the presumption argument. Instead, it argued the closeness of the claim to American territory should not prevent jurisdiction to bring suit against "a torturer or other common enemy of mankind."

The *Kiobel* decision is likely to lead to a significant reduction in international human rights litigation in U.S. courts under the ATCA. Plaintiffs will be able to bring claims against individual defendants for foreign acts of torture and extrajudicial killings under the Torture Victim Protection Act.⁸

International Discovery

Once the defendant is properly served and personal jurisdiction is obtained, the next issue is the ability to pursue **discovery** against him. **Discovery** is the process of gathering evidence from one's adversary and other third parties. Discovery is often the most difficult and costly part of international litigation. The United States Federal Rules of Civil Procedure allow for numerous and broad methods of discovery; other countries with less liberal discovery methods are less receptive to requests for the discovery of their nationals. The purpose of the Convention on the Taking of Evidence Abroad in Civil or Commercial Matters (**Hague Evidence Convention**) is to facilitate the discovery of foreign parties. This Convention provides for the use of **Letters of Request that require foreign courts to perform the discovery process**. It also provides for the "taking of evidence by diplomatic officers, consular agents and commissioners."

A number of factors limit the effectiveness of the Convention. First, few countries outside of the United States and Western Europe have adopted the Convention. Second, **a foreign court may reject a letter of request if the court deems it to be in violation of its national laws**. Nonetheless, a U.S. plaintiff having problems with foreign discovery should seek the help of the U.S. State Department in gathering evidence through the Hague Evidence Convention.

Enforceability of Judgments

After obtaining a judgment in an international litigation, the winning party will at times have to enforce the judgment in a foreign country, if the foreign defendant does not have enough assets in the forum court to satisfy the judgment. International litigation judgments are more difficult to enforce than arbitral awards. The court in *Hunt v. BP Exploration Ltd.*⁹ reviewed U.S. law on the enforcement of foreign judgments. The case involved the enforcement of an English judgment against a U.S. defendant. The court recognized that *Hilton v. Guyot*¹⁰ was still good law. In *Hilton*, the Supreme Court held that a foreign judgment is entitled to enforcement if the defendant had an opportunity for a fair trial. A fair trial is predicated on the foreign court possessing personal and subject matter jurisdiction, conducting trials using *regular* procedures, and acting “under a system of jurisprudence likely to secure an impartial administration of justice.” Despite this embrace of international comity, however, the court in *Hilton* failed to enforce the French judgment under a **rule of reciprocity**. The rule of reciprocity holds that a country will not enforce judgments rendered in a foreign country that does not likewise enforce its judgments. Because of the convergence of national legal systems and the United States’ recognition of other legal systems, the rule of reciprocity has rarely been used in recent years as a defense to the enforcement of a foreign judgment.

The most effective grounds for attacking a foreign judgment are procedural ones centered on due process and public policy concerns. In *Hunt*, the court held that given the historical deference received by English judgments, the *Hilton* due process standards were met given the similarities of the legal systems. However, a major substantive difference in the laws of the court rendering judgment and the enforcing court will be scrutinized during the enforcement stage. For example, U.S. courts will generally not enforce foreign country penal and tax judgments.¹¹ The court in *Hunt v. BP Exploration* did not enforce the English judgment pending its appeal in the English court system. It cited the *Uniform Foreign Money-Judgments Recognition Act*, which states that “if the defendant satisfies the court either that an appeal is pending or that he is entitled and intends to appeal from the foreign judgment, the court may stay the proceedings until the appeal has been determined or until the expiration of a period of time sufficient to enable the defendant to prosecute the appeal.”¹²

A number of **international conventions** have been promulgated **to help enforce judgments internationally**. Three are regional in nature: Members of the European Union can use the **Brussels Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters**. The **Lugano Convention** applies to all countries in the European Free Trade Area. Finally, the **Inter-American Convention on the Extraterritorial Validity of Foreign Judgments** applies to members of the Organization of American States. The only truly “international” convention, the **Hague Convention on International Jurisdiction and Foreign Judgments in Civil and Commercial Matters**, has not been widely accepted and has failed to be effective in facilitating the enforcement of foreign judgments.

In contrast, the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards or **New York Convention** has been widely accepted and enforced. Thus, the enforcement of a judgment in a foreign country is dependent upon the nuances of enforcement in that particular country. For example, France and Switzerland refuse to enforce a foreign judgment against their nationals unless there is a clear indication that the national voluntarily intended to submit to the jurisdiction of the foreign court. Many countries will not enforce U.S. judgments that are contrary to their public policy. Foreign courts, for example, are unlikely to enforce punitive and treble damage awards because there are no such counterparts under their laws. Faced with such obstacles, a plaintiff may choose to file suit directly in the country of the defendant or to arbitrate the claim.

Choice of Law

How do courts determine which national laws apply in a given case? Generally, absent a **choice of law clause** in which the **parties to a contract expressly state the law that will govern any disputes, the law of the country most closely connected to the agreement will govern**. Sometimes the courts may apply the principle of *dépeçage* to apply different governing laws to different parts of the contract. In short, different parts of the contract may have closer connections to different countries. The country of closest connection will often be the country of the residence of

Specific Rules	
Sale/purchase contract	law of the country of the seller
Lease contract	law of the country of the lessor
Banking/credit contract	law of country of the financial institution
Employment contract	law of the country in which the services are performed; when services are to be performed in more than one country, then law of the country of the employer
General Default Rule	
If specific rules are not applicable	law of the country of the party performing the principle obligation

Figure 4.1 *Comparative Law*: Hungarian Conflict of Law Rules.

the performing party. Courts have fashioned **conflict of law rules** to assist them in making choice of law decisions. These rules are essentially a list of factors used to determine the country with the closest connection to the case.

Under the *Restatement (Second) of Conflict of Laws*,¹³ the law of the jurisdiction with the “most significant contacts” governs both tort and contract claims. In **evaluating tort claims**, the following four factors are relevant: (1) the domicile, place of incorporation, and place of business of the parties; (2) the place where a tort occurred; (3) the place where the relationship of the parties is centered; and (4) the place where the injury occurred. With respect to contract claims, the factors are: (1) the place of contracting; (2) the place of negotiation; (3) the place of performance; (4) location of the subject matter of the contract; and (5) the domicile, place of incorporation, and place of business of the parties. The Restatement also states that if the place of negotiating the contract and the place of performance are in the same country, the law of that country will usually be applied. If a specific contract clause or issue is invalid in a country with a close connection to the contract, then that country’s laws may be deferred to because of its strong interest in enforcing its laws and public policies. The **doctrine of renvoi** is **when a court uses another country’s conflict of law rules that direct the court to apply its own country’s law**. Other factors considered include the place the contract was negotiated, the place the contract was signed, the place of performance, and the place the breach occurred.

Before a contract and a choice of law clause are drafted, the conflict of law rules in the national law of the other party should be researched. This will help determine whether an express choice of law clause is needed and, if so, the factors the foreign country will use in assessing the enforceability of the choice of law selection. An example of conflict of law rules or factors is found in Figure 4.1 *Comparative Law*: “Hungarian Conflict of Law Rules.”

One principle used in determining the law to be applied by the forum court is that, absent sufficient proof to establish with reasonable certainty the substance of the foreign law, the court should apply the law of the forum. A court is not expected to decide a case based on incomplete and frequently confusing explanations of foreign law. In *Banque Libanaise Pour Le Commerce v. Khreich*,¹⁴ the Federal Circuit Court stated that it was the plaintiff’s “burden to provide the legal pigment and then paint the district court a clear portrait of the relevant foreign (Abu Dhabi) law.” It affirmed the right of the lower court to apply Texas law to what was primarily a foreign transaction.

Judicial Abrogation of Choice of Law Clauses

Internationally, courts and arbitration tribunals have generally enforced contractual choice of law clauses. Courts, however, will usually require that the choice of law have some connection to the parties to the contract. Arbitration tribunals, on the other hand, are more likely to enforce a reasonable choice of law selection even if the choice is not connected to the contract or the transaction. Arbitrators may see an **unconnected choice of law selection as a fair compromise given the international nature of the transaction**. This is especially true if the parties’ choice is one of the more popular neutral country laws, such as the UK, the United States, Switzerland, and Germany.

At times, statutory mandates may preempt this reasonableness inquiry. For example, the English Unfair Contract Terms Act of 1977 adopts a presumption of unreasonableness for indemnity clauses, which “by reference to any contract term a party is made to indemnify another party in respect of liability for negligence or breach of contract.”¹⁵ For international sales contracts, the Act voids any choice of law clause whose purpose is the avoidance of the Unfair Terms Act.

Courts have used a number of factors in scrutinizing choice of law clauses. The following excerpts from the *Restatement (Second) of Conflict of Laws* provide the rationale for the need for such rules and the factors that courts review in deciding whether to honor a choice of law selection.

Section 1: Reason for the Rules of Conflict of Laws

The world is composed of territorial states having separate and differing systems of law. Events and transactions occur, and issues arise, that may have significant relationships to more than one state, making necessary a special body of rules and methods for their ordering and resolution.

Section 6: Choice-of-Law Principles

The **factors relevant to the choice of law** include:

- a *the needs of the international system,*
- b *the relevant policies of the forum,*
- c *the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue,*
- d *the protection of justified expectations,*
- e *the basic policies underlying the particular field of law,*
- f *certainty, predictability, and uniformity of result, and*
- g *ease in the determination and application of the law to be applied.*

In weighing these factors, **the modern judicial trend is to give great deference to the choice made by the parties in their contractual choice of law clause.** “In the area of contracts, where choice-of-law rules are uncertain, some measure of predictability and certainty is achieved by allowing the parties, within broad limits, to select the law to govern the validity and effect of their contract.”¹⁶ This deference also advances the policy goal of protecting “the justified expectations” of the contracting parties.

The *Restatement* also provides **two grounds for abrogating the parties' choice of law clause.** **First**, the chosen law has no substantial relationship to the parties or the transaction, and there is no reasonable basis for the parties' choice. **Second**, application of the law of the chosen state would be contrary to a fundamental policy of a country, which has a materially greater interest than the chosen state in the determination of the particular issue. A forum court is unlikely to enforce a choice of law that would be contrary to its county's law and policy.

International Commercial Arbitration

The arbitration rules that apply to the arbitral proceeding are those stated in the arbitration clause. **When there is no arbitration clause,** then the rules would need to be agreed upon by the parties through a **voluntary submission for arbitration.** The enforcement of arbitration awards from one country against the losing party in another country has been made much easier due to the fact that over 160 countries have ratified the New York Convention. It is much easier and certain to have an arbitration award enforced in foreign countries than judgments issued by courts. Since arbitration awards are considered final and binding, the losing party cannot fight their enforcement by arguing the arbitration panel wrongfully decided the case. However, the **New York Convention** allows the **nonenforcement of an arbitration award** on **narrow grounds** unrelated to the substance of the case: (1) the award has been stayed by

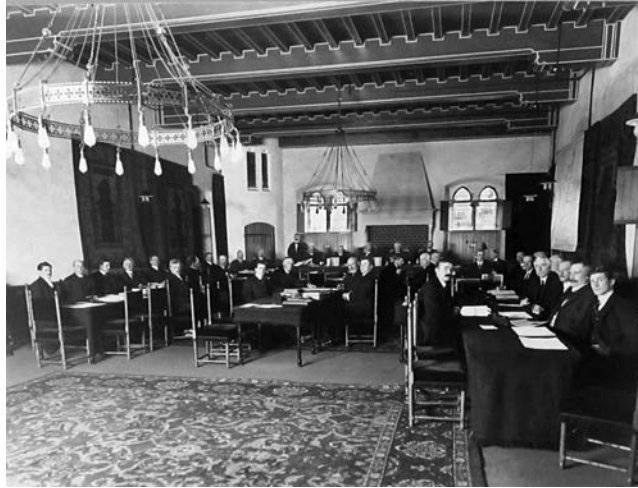


Image 4.1 1910 North Atlantic Fisheries Arbitration at The Hague.

Law Society of Upper Canada Archives.

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another court, (2) the characteristics of the arbitrators or the arbitration procedures were in conflict with the arbitration agreement, (3) the losing party was not given proper notice or opportunity to present its case, (4) the arbitration decided issues not within the scope of the arbitration agreement, and (5) the arbitration agreement was invalid.

The costs, inefficiency, and unpredictability of national court systems has made international arbitration the preferred means of dispute resolution in international business transactions. **ADR (Alternative Dispute Resolution)** represents a contractual response to the cost and inefficiency of the ordinary civil justice system (litigation). First, the civil procedure rules vary greatly among national legal systems. A party may be comfortable when litigating within its domestic court system, but wary of having to sue in a foreign court system. Second, well-recognized national and international arbitration tribunals provide the aura of neutrality that parties seek in resolving their disputes.

International commercial arbitration can be institutionalized through the use of standard rules provided by such organizations as the **American Arbitration Association (AAA)** or the **International Chamber of Commerce (ICC)**, or it can be done on an *ad hoc* basis. Arbitration offers the potential for a shortened, cost-effective, confidential, and hopefully more amicable means to resolve a dispute. It allows the parties to select arbitrators with the necessary expertise to understand the technicalities of the issues in dispute. Also, an unusual choice of law is more likely to be sustained by a panel of arbitrators than by national courts of law. Unlike courts, arbitrators' primary mandate comes from the contractual arbitration clause and not national public policy concerns. The confidentiality of arbitration, especially in disputes involving sensitive information, is another reason why arbitration is a preferred means of dispute resolution. The largest area of growth in international arbitration has been in East Asia. See Figure 4.2 *Doing Business Internationally*: “International Commercial Arbitration in East Asia.”

The simplest solution to a payment problem is to contact and negotiate with the customer. With patience, understanding, and flexibility, one can often resolve conflicts to the satisfaction of both sides. If, however, negotiations fail and the sum involved is large enough to warrant the effort, a company should obtain the assistance

The recent growth of major arbitral associations in East Asia is borne by statistical analysis. In 2005, the total number of arbitration cases received by major international arbitration institutions in Western nations—the American Arbitration Association (AAA), the International Chamber of Commerce’s International Court of Arbitration (ICC), the London Court of International Arbitration (LCIA), and the international arbitration centers in Stockholm, Vienna, and Vancouver—was 1,407. This figure was surpassed by the combined total number of cases received by prominent international arbitration institutions located in East Asia—the China International Economic and Trade Arbitration Commission (CIETAC), Japan Commercial Arbitration Association (JCAA), Hong Kong International Arbitration Centre (HKIAC), Kuala Lumpur Regional Center for Arbitration (KLRCA), Singapore International Arbitration Centre (SIAC), and the Korean Commercial Arbitration Board (KCAB) collectively received 1,433 cases.¹⁷

China International Economic and Trade Arbitration Commission (CIETAC) has become one of the busiest arbitration venues for international commercial contract disputes (approximately 700 cases per year).¹⁸ The rise of China as a major arbitration venue is understandable due to its rise as an economic power. But, its seemingly smooth transition to a major player in international commercial arbitration has been traced to Eastern philosophy and tradition. China’s Confucian tradition placed a premium on nonformal, conciliatory (*tiao jie*) methods of business dispute resolution.¹⁹ Based upon its history, despite East–West cultural differences, CIETAC has proven its ability in reaching fair and reasonable outcomes using Western-style hard and soft commercial laws. In fact, it has proven itself to be a model arbitral forum. Shahla Ali notes that: “East Asian international arbitration proceedings exhibited a greater regard for the amicability, confidentiality, voluntary compliance, and efficiency of international arbitration proceedings than their North American and European counterparts.”²⁰

Figure 4.2 *Doing Business Internationally*: International Commercial Arbitration in East Asia.

and advice of its bank, legal counsel, and other qualified experts. If both parties can agree to take their dispute to an arbitration agency, this step is preferable to legal action, since arbitration is often faster and less costly. **The ICC handles the majority of international arbitrations and is usually acceptable to foreign companies because it is not affiliated with any single country.**

Litigation is the less-preferred method of dispute resolution in many countries. It is seen in some countries, most notably in Japan, as a failure of the businessperson *qua* businessperson. (See Figure 4.3 *Doing Business Internationally*: “The Role of Alternative Dispute Resolution in Japan.”) In “some cultures arbitration may prove a ‘face-saving’ approach to dispute resolution.”²¹ **From a more practical perspective, litigation is an expensive process likely to permanently damage the business relationship and is inherently unpredictable as to result.** International litigation is **often unduly delayed because of a lack of uniformity in procedural rules.** For example, the liberalized nature of U.S. discovery rules often meets with hostility in foreign courts.

The uncertainty of dispute resolution in a foreign country is generally more manageable through arbitration than through the national court system. This is especially true in former Soviet-bloc countries and developing countries where the enforcement of new substantive laws is uncertain and uneven. Furthermore, even when enforced, the remedies granted may be insufficient to fully protect the contract and property rights of the foreign party. In general, arbitral awards rendered in countries party to the New York Convention are readily enforceable in all other signatory countries.

For export transactions, additional advantages are neutrality, the avoidance of either party’s domestic courts, and ease of enforcement. In an agreement to arbitrate, usually consisting of a clause inserted in the contract, the parties also have broad powers to specify many significant aspects of the arbitration. The arbitration clause may appoint an arbitration institute and name the arbitration location, the law and rules that will govern qualifications of the arbitrators, and the language in which the arbitral proceedings will be conducted.

For an international arbitration to work effectively, the national courts in the countries of both parties to the dispute must recognize and support arbitration. Should one party attempt to avoid arbitration after a dispute has arisen, the other party must be able to rely on the judicial system in either country to enforce the agreement to arbitrate. In addition, the party that wins in the arbitration proceeding must be confident that the national courts will enforce the decision of the arbitrators. The federal policy of the United States is to approve and support resolution of disputes by arbitration. Through the UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention), which the United States ratified in 1970, and many more countries since have

The Japanese have characteristically been reluctant to litigate disputes. The Japanese litigation system promises up to a ten-year wait before a controversy is resolved. There is a cultural aversion to conflict based on ingrained notions of *wa* or peace and harmony. Informal resolution usually preserves the relationship between the parties. It removes the stigma of blame or fault associated with one who is found guilty or liable. The Japanese attitude toward compromise, conciliation, and arbitration is discussed below.

Compromise. Compromise or *wakai* differs from out-of-court settlement negotiations in that it involves a judge. In *benron-ken wakai*, the parties present their cases orally before the judge and, with the judge, explore areas of compromise. In *soshino wakai* or “compromise before the court,” after thorough discussions with both parties, the judge generates compromise proposals. Compromise offers obvious benefits not found in traditional litigation. A compromise may preserve peace and the status quo and come at the expense of the legitimate expectations of one of the parties; unlike in a court of law, the judge in compromise proceedings is free to disregard the legal merits and standing of the parties in order to settle the dispute equitably and restore a sense of harmony between the parties. As a ruler under Confucian principles, the judge is bound to act with compassion and benevolence. The compromise proceedings are confidential. The compromise agreement represents a voluntary contract; parties are always free to refuse a judicially sponsored settlement,

but the same judge presiding over the compromise proceedings would also hear the case at trial.

Conciliation. Conciliation or *chetei* may be initiated by application of the parties or by the court, and may occur while a lawsuit is pending. Unlike with court-sponsored compromise, a court appoints a conciliation committee. A conciliation commissioner must be a lawyer, must have expert knowledge and experience useful in settling disputes, and must possess “rich knowledge and experience in public life.” There is, however, no guarantee that the outcome will reflect the legal merits of the case. Indeed, it has been described as “OK, OK (*maamaa*)” or “fifty/fifty (*seppan*)” conciliation because of the overriding emphasis placed on settling the dispute and restoring harmony.

Arbitration. Japanese arbitration or *chsaai* can be divided into two categories: arbitration conducted between two Japanese parties, and arbitration conducted between a Japanese party and a foreign party. Arbitration has not been favored as a method of dispute resolution among the Japanese because, like litigation, arbitration involves the “imposition” of a settlement by a third party and therefore cannot restore the harmony disrupted by the dispute. Arbitration has, however, gained widespread acceptance as a means of resolving disputes in international business transactions between Japanese and foreign parties. Arbitration allows Japanese concerns to negotiate “equitable positions as opposed to purely legal technicalities” and to avoid extensive pretrial discovery battles that serve only to “exacerbate the conflict.”

Figure 4.3 *Doing Business Internationally*: The Role of Alternative Dispute Resolution in Japan.²²

undertaken international legal obligations to recognize and enforce arbitral awards, of which the People’s Republic of China is the most recent. For the key provisions of the New York Convention, see Figure 4.4 *Comparative Law*: “Convention on the Recognition and Enforcement of Foreign Arbitral Awards.” **The New York Convention is by far the most important international agreement on commercial arbitration and may be credited for much of the explosive growth of arbitration in international business disputes.**

Article I

When signing, ratifying or acceding to this Convention any State may on the basis of reciprocity declare that it will apply the Convention to the recognition and enforcement of awards made only in the territory of another Contracting State. It may also declare that it will apply the Convention only to differences arising out of legal relationships, whether contractual or not, which are considered as commercial under the national law of the State making such declaration.

Article II

Each Contracting State shall recognize an agreement in writing under which the parties undertake to submit to arbitration all or any differences which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not, concerning a subject matter capable of

settlement by arbitration. The term “agreement in writing” shall include an arbitral clause in a contract or an arbitration agreement, signed by the parties or contained in exchange of letters or telegrams.

Article III

Each Contracting State shall recognize arbitral awards as binding and enforce them in accordance with the rules of procedure of the territory where the award is relied upon, under conditions laid down in the following articles.

Article IV

To obtain the recognition and enforcement mentioned in the preceding article, the party applying for recognition and enforcement shall, at the time of the application, supply a duly authenticated original award or certified copy.

Figure 4.4 *Comparative Law*: Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958).

The Convention provides for the full recognition of contract arbitration clauses and outlines a narrow set of grounds for the nonenforcement or vacating of an arbitration award. These include: (1) where an award was procured by corruption, fraud, or undue means; (2) where there was evident partiality or corruption in the arbitrators; (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing or in refusing to hear evidence pertinent and material to the controversy; (4) where the arbitrators exceed their powers; (5) where there was evident miscalculation of figures; and (6) where the arbitrators have awarded upon a matter not submitted to them. The *Iran Aircraft Industries v Avco Corporation* case below examined the issue of the enforceability of a foreign arbitration award.

Iran Aircraft Industries v. Avco Corporation

980 F.2d 141 (2d Cir. 1992)

Lumbard, Circuit Judge. The district court declined to enforce an award of the Iran-United States Claims Tribunal, which resulted in an award of \$3,513,086 due from Avco to the Iranian parties. The Iranian parties contend that the Award is enforceable under the “New York Convention.”

New York Convention

Avco argues that the district court properly denied enforcement of the Award. The New York Convention, however, provides for non-enforcement where: “The party against whom the award is invoked was not given proper notice of the appointment of the arbitrator or of the arbitration proceedings or was otherwise unable to present his case.” In this case, Avco was not made aware that the Tribunal required actual invoices to substantiate its claim. We believe that by so misleading Avco the Tribunal denied Avco the opportunity to present its claim in a meaningful manner.

AFFIRMED.

Cardamone, Circuit Judge, dissenting. The specific defense with which we deal in the case at hand appears

in Article V (1)(b). That section states that enforcement of an arbitral award may be denied if the court is satisfied that the party against whom the award is sought to be enforced was unable to present its case before the arbitration panel. Avco was not denied due process before the Iran-U.S. Claims Tribunal. The ruling by the Hague Tribunal in the instant matter was not high-handed or arbitrary. A reading of prior cases reveals that they involved arbitration hearings actually cut short and not completed before an award was rendered. The present case is vastly different. Avco had a full opportunity to present its claims, and was on notice that there might be a problem with its proof. I dissent and vote to enforce the award.

Case Highlights

- The New York Convention requires U.S. courts to enforce foreign arbitration awards.
- Enforcement of an arbitration award may be withheld if the losing party was denied due process.
- Due process requires the defendant be given proper notice and an opportunity to be heard.

It should be noted that an arbitration clause does not and should not completely separate the arbitration from the court system. At least in two instances the court system is crucial to the vitality of the arbitration process. The first is the most obvious—the arbitration award must be enforced through the court system. An unenforceable award renders the arbitration process an empty exercise. Fortunately, the New York Convention has provided security of enforcement in many national jurisdictions. Nonetheless, the arbitration clause should expressly state that the parties consent to the jurisdiction of any competent court for purposes of the enforcement and satisfaction of any award. Establishing an escrow account before arbitration commences will make enforcement less problematic and court-dependent. The parties can be required to deposit money, letters of credit, or insurance bonds. The arbitration clause should then provide that the arbitrator is empowered to release the funds held in escrow to satisfy any award.

A second role for the court system is in granting injunctive relief pending the outcome of the arbitration. The arbitration clause may provide that the parties can apply to the arbitrators for injunctive relief, but the arbitrator's ability to restrain the parties may be legally ineffective. Thus, the clause should also allow the parties to resort to the court system. This provision is especially important in the area of intellectual property, where the critical need to restrain the release of confidential information and trade secrets makes injunctive relief a necessity. It is important for the aggrieved party to maintain the status quo pending the outcome of the arbitration process.

The sensitivity of the information may also dictate a clause that restrains the release of information within the arbitration process. The clause should reiterate that all information provided in the arbitration is to remain private and confidential. Release of such information by one of the parties would be a ground for a separate claim. The next section discusses the parameters for negotiating a proper arbitration clause.

Applicable Law

While not necessary, it is desirable to identify in the contract (or the agreement to arbitrate) the substantive or applicable law (or governing law) that will govern the resolution of the dispute. Failure to clarify this issue may increase the time and cost of an arbitration. When deciding upon the applicable law, factors to consider include: (a) a legal system that has developed a body of law relating to the specific issues likely to arise; (b) whether only the laws that regulate the subject-matter (substance) of the dispute should apply, or if the applicable law of a country also includes international law rules within that country that may, in turn, refer the dispute to the law of another country (known as conflict of law provisions); and (c) whether the chosen governing law considers the subject matter of the contract to be arbitrable. In some countries, for example, copyright, patent, and antitrust matters do not qualify as arbitrable matters.

There are a number of choice of law issues that relate to arbitration, including the applicable law of the contract, the law that determines the validity of the arbitration agreement, the law of the arbitration proceeding, and the law governing the enforcement of the arbitration award. The substantive law that applies to the contract is generally determined by the parties through a choice of law clause in the contract. If there is no choice of law clause the arbitration panel will use conflict of law rules to determine the applicable law. Some arbitration rules will provide guidance, such as the International Centre for Settlement of Investment Disputes (ICSID) where it states that the law of the host state shall apply. However, most arbitration rules are silent, giving the arbitration panel wide discretion in choosing the law to apply to the dispute.

The severability principle recognizes the arbitration clause in a contract as a separate agreement independent of the contract. Therefore, a law is needed to determine the validity of the arbitration clause. Also, if viewed as a separate agreement, then it can be enforced even if the underlying contract is determined to be invalid or unenforceable. The U.S. Federal Arbitration Act states that an arbitration clause is "valid, irrevocable, and enforceable." U.S. courts have held that the arbitration law of the court hearing the dispute is the applicable law, while others have applied the law of the contract. The New York Convention states the law of the location of the arbitration applies, thus denying the use of conflict of law rules.

Dépeçage is the principle that recognizes that in some cases different laws may apply to different issues in the dispute. In the sale of goods, Convention on Contracts for the International Sale of Goods (CISG) may be the applicable law, but the CISG is not a comprehensive law. Therefore, if an issue is not dealt with in the CISG then recourse must be made to a national law. In such cases, the choice of law clause should select a national law to be applied in areas where there are "gaps" in the CISG. Renvoi recognizes that when the parties choose a national law, that country's conflict of law rules apply to the dispute. In some instances, to the regret of the parties, those conflict of law rules may lead a court or arbitral tribunal to the law of another country than the one selected in the choice of law clause. For example, an American seller has superior bargaining power over a French buyer and, therefore, negotiates that the choice of law will be New York State law. However, when a dispute arises the court or arbitral panel applies New York conflict of law rules, which show that the law closest to the case is French law. To avoid this problem, the choice of law clause should clearly state that the substantive law of New York should apply without any reference to New York's conflict of law rules.

No Law Alternative

The parties may want to choose a law, but allow the arbitration panel some leeway in not having to strictly apply the chosen law. Alternatively, they may select no law at all and instruct the arbitration panel to simply make a fair and equitable award. The traditional terms of *ex aequo et bono* and *amiable compositeur* refer to the ability of the arbitration panel to use any source of law, including customary international law (business customs and trade usage) to render a fair and equitable decision.

Arbitration Rules

One thing that is important to realize in the selection of the set of arbitration rules that will govern a dispute between the contracting parties is that such rules set a general framework but do not provide many specifics, which can only be accomplished by a custom drafted arbitration clause. They do not specify how and whether documents are to be presented to the arbitration panel or how the arbitration hearing is to be conducted. The benefit of this system is that it gives the parties the ability to select arbitration rules and at the same time tailor them to their specific needs. The detriment is that contracting parties, and their lawyers, often do not spend the time to negotiate a customized clause.

The rules that govern arbitration come from multiple sources. The primary source is the arbitration clause found in the contract between the transacting parties. The contract may provide for a customized set of arbitration rules or select a set of arbitration rules provided by an arbitration association. The arbitration clause may also select a hybrid of rules from different sources to cover different dispute resolution procedures (mediation, conciliation, arbitration) or different issues (tort claims, contract claims, claims against a government, etc.). For example, the parties may choose the UNCITRAL (United Nations Commission on International Trade Law) Model Law on International Commercial Arbitration as the rules governing their arbitration and at the same time adopt the rules of the International Bar Association on the Taking of Evidence. See Table 4.1 for a list of important arbitration rules and conventions.

Other important forums include: Arbitration Association of Stockholm; Cairo Regional Centre for International Commercial Arbitration (CRCICA); China International Economic and Trade Arbitration Commission (CIETAC); Hong Kong International Arbitration Commission (HKIAC); Moscow Arbitration Court; and the Vienna International Arbitration Centre (VIAC). The Panama Convention is important since 17 countries in Central and South America including Mexico and the United States have adopted it. The Washington Convention is important in that it allows private individuals to sue a foreign government directly in suits involving foreign direct investment. It also provides a process for one country to sue another country for violation of a bilateral investment treaty. For purposes of managing international arbitrations, the AAA has established the International Center for Dispute Resolution (ICDR). The ICDR has offices in Bahrain, Mexico City, and Singapore.

Table 4.1 Important Conventions, Sets of Arbitration Rules, and Forums

<i>Conventions</i>	<i>Arbitration Rules</i>	<i>Arbitration Forums</i>
1958 UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention)	International Chamber of Commerce (ICC)	International Court of Arbitration (ICC)
Inter-American Convention on International Arbitration (Panama Convention)	UN Model Law on International Commercial Arbitration (UNCITRAL Arbitration Rules)	London Court of International Arbitration (LCIA)
European Convention on International Commercial Arbitration	American Arbitration Association (AAA)	International Center for Dispute Resolution (AAA)
Convention on the Settlement of Investment Disputes (Washington Convention)	UNCITRAL Model Law on International Commercial Conciliation	International Centre for Settlement of Investment Disputes (ICSID)

There are a number of **methods of conducting arbitration**. One interesting one is **last offer arbitration**. In this form of arbitration **each party provides a single “best offer” and the arbitrator must select one of the two offers**. The parties are incentivized to provide reasonable offers (somewhere between their original positions and the position of the other party). If a party makes an unreasonable offer to settle, then it is likely to lose since the arbitrator will select the more reasonable offer. The benefit of this approach is that the arbitration process moves to a quicker resolution.

Ad Hoc versus Institutional Arbitration

In negotiating an arbitration clause, the contracting parties must first decide their preference of ad hoc arbitration or institutional arbitration. Institutional arbitration has the benefit of providing a well-drafted, unbiased set of arbitration rules, and the award will be considered to be highly credible given the prestige of the institution. However, ad hoc arbitration may be more cost-effective and the parties’ can choose the UNCITRAL Arbitration Rules to govern the arbitration. **Institutional arbitration is dispute settlement proceedings supervised by an organization or institution, in accordance with the rules of arbitration established or approved by that institution**. By choosing institutional arbitration, **the parties or institution rely on the expertise of the institution and its resources for selecting arbitrators and for administering or managing the arbitration**. As a general proposition, the arbitration clause used should be coordinated with and reflect the arbitral rules of the institution or ad hoc procedure chosen. If institutional arbitration is chosen, **it is usually not necessary that the institution chosen be located in the place of arbitration**. For example, the ICC administers arbitrations throughout the world.

Ad hoc arbitration means there is **no formal administration of the arbitration** or dispute settlement process by any established arbitral organization. Instead, **the parties create their own procedures for the arbitration**. This can be accomplished, for example, either by: (1) drafting a set of ad hoc procedures in a contract; (2) referring to a set of generally accepted ad hoc arbitration rules, such as the UNCITRAL Model Arbitration Rules; or (3) allowing the arbitration tribunal to produce its own procedures after the dispute has arisen. **Ad hoc arbitration can sometimes be less expensive, but it places more of a burden on the parties to organize and administer the arbitration**.

UNCITRAL Model Arbitration Rules

The UNCITRAL Arbitration Rules provide a **comprehensive set of procedural rules upon which parties may agree for the conduct of arbitral proceedings arising out of their commercial relationship** and are **widely used in ad hoc arbitrations as well as administered arbitrations**. The Rules cover all aspects of the arbitral process, providing a model arbitration clause, setting out procedural rules regarding the appointment of arbitrators and the conduct of arbitral proceedings, and establishing rules in relation to the form, effect, and interpretation of the award.

The original UNCITRAL Arbitration Rules were adopted in 1976 and have been used for the settlement of a broad range of disputes, including disputes between private commercial parties where no arbitral institution is involved, investor–State disputes, State-to-State disputes, and commercial disputes administered by arbitral institutions. In 2006, the Commission decided that the UNCITRAL Arbitration Rules should be revised in order to meet changes in arbitral practice over the last 30 years. The revision is aimed at enhancing the efficiency of arbitration under the Rules, but does not alter the original structure of the text, its spirit, or drafting style.

The UNCITRAL Arbitration Rules, as revised, have been effective since August 15, 2010. They include provisions dealing with, amongst others, multiple-party arbitration and joinder, liability, and a procedure to object to experts appointed by the arbitral tribunal. A number of innovative features contained in the Rules aim to enhance procedural efficiency, including revised procedures for the replacement of an arbitrator, the requirement for reasonableness of costs, and a review mechanism regarding the costs of arbitration. They also include more detailed provisions on interim measures. Table 4.2 provides excerpts from the UNCITRAL Arbitration Rules and shows some issues relating to commercial arbitration. These issues could be settled by customized arbitration clauses, which will be discussed in the next main section on “Custom Arbitration Clause.”

Such countries as Australia, Austria, Canada, Chile, Croatia, Denmark, Egypt, Estonia, Germany, Greece, Hong Kong (China), Hungary, India, Ireland, Japan, Mexico, Nigeria, Norway, Philippines, Poland, Russia, Singapore, South Korea, Spain, Thailand, Turkey, Ukraine, Venezuela, and the American States of California, Connecticut, Florida, Illinois, Louisiana, Oregon, and Texas have adopted the UNCITRAL Model Arbitration Rules.

*Arbitration and the Principle of Equitable Decision-Making*²³

“Rules of international law can be established in three main ways: (1) by international, formal agreement, usually between States; (2) in the form of international custom; and (3) by derivation of principles common to major world legal systems.”²⁴ The first type is the domain of international hard law. The CISG is a form of international hard law but will also be examined here as a source of soft law. The second type is the area of soft law, most commonly seen in the practices, usage, and customs of international merchants. The third type is seen in both international public and private law. In the area of international private law, a comparative analysis of national contract law regimes can uncover basic, core principles common to most private law systems, such as freedom of contract and the principle of good faith. Often hard and soft laws are distinguished with the former being mandatory or binding law and the latter being considered as voluntarily applied to support the application of hard law (or a given interpretation of a hard law) or to create a new rule or principle application when hard law fails to provide a solution.

One advantage of arbitration is that arbitral tribunals are not restricted by formal rules of civil procedure or restrictive rules of evidence.²⁵ As such, commercial arbitrators often seek solutions from commercial practice and trade usage. In addition, they feel less restrictive in using other types of soft law in fabricating fair and reasonable awards. Before and subsequent to the 2008 world financial crisis, soft law has played an important role in regulating financial institutions and their relationships.

In recent times there has been a renewed interest by scholars, lending institutions, and regulators in Islamic financial law. It has been studied and utilized as an alternative source for resolving financial disputes. “It is noteworthy that there is no rule in Islamic jurisprudence that precludes following international commercial arbitration procedures, as long as the selected procedure ensures justice for all parties and does not conflict with the basic principles of Islam.”²⁶ The notion of customary practice is strong in the Islamic legal system: “Some Islamic jurisprudence schools consider *urf*, the Arabic for custom, and public interest, as sources for determining the *Shari’a* position on certain issues. This has resulted in the formation of many different schools of thought, or *madhabs* as are they known in Arabic.”²⁷ Islamic financial law as customary law and the Islamic dispute resolution system has a good amount of commonality with arbitration. The major difference between international arbitration and *Shari’a* include that the parties are not free to select their governing law through a choice of law clause. Muslims are obligated to apply *Shari’a* law to resolve all their disputes.²⁸ And a limited judicial review is necessary to ensure that the award is consistent with the principles of Islamic law.²⁹ In the end, it is plausible to state that in the area of financial arbitration, the acceptance and the interpretation of arbitration agreements have been notably influenced by *Shari’a* law, as it is the primary source of law and public policy in many countries in the Islamic world. The growth in business relations between international companies and the Islamic world, mainly in the Middle East, in addition to the expansion of Islamic finance, highlight the importance of understanding the attitude of *Shari’a* law in international arbitration.³⁰

The voluntary use of Islamic financial law is a recent example of how commercial contract law disputes are especially conducive and open to the application of soft law. Due to contract law’s private nature, arbitrators and courts look to the parties’ characteristics (diamond merchants, cotton exporters, and so forth); the totality of the circumstances surrounding their formation of a contract, including the trade usage and business customs found in a given trade; and in business in general. Indeed, contract law—whether the Chinese Contract Law (CCL), CISG, American Uniform Commercial Code (UCC), or the German Civil Code (BGB)—acts much like soft laws due to the contracting parties’ ability to derogate from the individual default rules of these supposedly hard laws. Lisa Spagnolo argues that the CISG, although a mandatory law, unless there is a choice of law that states otherwise, should be viewed or applied as if it was a soft law.³¹ Spagnolo reasons that in the interpretation of CISG rules the CISG would be better used by applying its underlying purposes in place of a purely doctrinal approach to

Table 4.2 UNCITRAL Arbitration Rules

Article and Title	Excerpts from the Rules
Article 7 Number of Arbitrators	If the parties have not previously agreed on the number of arbitrators then <i>three arbitrators</i> shall be appointed.
Article 9 Selection of Arbitrators	If three arbitrators are to be appointed, each party shall appoint one arbitrator. The two arbitrators will then choose the third arbitrator who will act as the presiding arbitrator of the arbitral tribunal.
Article 12 Challenge an Arbitrator	Any arbitrator may be challenged if circumstances exist that give rise to justifiable doubts as to the arbitrator's <i>impartiality or independence</i> .
Article 17 Arbitration Hearing	Subject to these Rules, the arbitral tribunal may conduct the arbitration in such manner, as it considers appropriate, provided that the parties are treated with equality and each party is given a <i>reasonable opportunity</i> of presenting its case.
Article 23 Jurisdiction of Arbitrators	The arbitral tribunal shall have the power to rule on its own jurisdiction, including any objections with respect to the existence or validity of the arbitration agreement. For that purpose, an arbitration clause that forms part of a contract shall be treated as an agreement <i>independent</i> of the other terms of the contract. A decision by the arbitral tribunal that the contract is void does not automatically invalidate the arbitration clause.
Article 26 Interim Measures	The arbitral tribunal may, at the request of a party, grant interim measures (orders or injunctions). A request for interim measures addressed by any party to a judicial authority shall not be deemed incompatible with the agreement to arbitrate, or as a waiver of that agreement.
Article 27 Evidence	<ol style="list-style-type: none"> 1 Witnesses, including expert witnesses, may be presented by the parties to provide expert evidence or to verify issues of fact. 2 The arbitral tribunal may require the parties to produce documents, exhibits, or other evidence within such a period of time, as the arbitral tribunal shall determine.
Article 29 Experts	After consultation with the parties, the arbitral tribunal may appoint one or more independent experts to report to it, in writing, on specific issues to be determined by the arbitral tribunal.
Article 34 Form of Award	The arbitral tribunal shall state the reasons upon which the award is based, unless the parties have agreed that no reasons are to be given.
Article 35 Applicable Law	<ol style="list-style-type: none"> 1 The arbitral tribunal shall apply the rules of law designated by the parties as applicable to the substance of the dispute. Failing such designation by the parties, the arbitral tribunal shall apply the law, which it determines to be appropriate. 2 The arbitral tribunal shall decide as amiable compositeur or <i>ex aequo et bono</i> only if the parties have expressly authorized the arbitral tribunal to do so. 3 In all cases, the arbitral tribunal shall decide in accordance with the terms of the contract, if any, and shall take into account any <i>usage of trade</i> applicable to the transaction.
Article 42 Allocation of Costs	The costs of the arbitration shall in principle be borne by the unsuccessful party or parties. However, the arbitral tribunal may apportion each of such costs between the parties if it determines that apportionment is reasonable, taking into account the circumstances of the case.

interpretation. Instead arbitrators should focus on reconstructed party intent, good faith, and trade usage in interpreting CISG rules. In other instances, domestic laws, such as the English Sale of Goods Act and the Swiss Civil Code, have been used as neutral “soft” laws in seeking out a reasonable decision in an international dispute where the arbitrators are not restricted to a mandatory national law.

In many cases, arbitral panels will consider numerous sources of hard and soft laws in their attempts to render fair and equitable decisions. Unlike national courts, often bound by hard law, arbitrators are more willing and able to

use sources of law, including soft law, in rendering their decisions. While most legal systems recognize a strict hierarchy of sources of law where the lower sources of the hierarchy are prohibited from conflicting with higher sources, arbitral panels may and should view sources of law in a less hierarchical way. In commercial contract law, customary law, including business customs, trade usage, and commercial practice, should, in certain contexts, be given more weight than the default rule provided by a convention or code.

Soft law comes in many different forms, from general, abstract principles to the minutiae of highly technical trade usages. In the European Union, the European Court of Justice has observed general principles found in member states in interpreting European Union law. One of the oldest types of soft law is the *lex mercatoria*,³² which has been many centuries in development. One scholar asserts that there have been three eras of the *lex mercatoria*. Soft law “first appeared under the semblances of the Roman *ius gentium*, as the formally autonomous source of law regulating the economic relations between Roman citizens and foreigners.”³³ Soft law “reappeared in the 11th century under the guise of the *lex mercatoria*,” which developed as a body of merchant customs and practices.³⁴ High points include the development of international financial instruments and principles of trade by the Italian city-states of Venice, Florence, and Genoa. Eventually there was the development of English merchant law and ad hoc merchant tribunals in Europe prior to the establishment of functioning court systems. “The *lex mercatoria* was self-enforced by the very merchant class that generated it, dispute settlement being organized through private merchant arbitration and enforcement. Guild courts, market courts, and fair courts were non-professional tribunals consisting of merchants or guild members elected by their fellows and occasionally assisted by professional notaries. An efficient system of merchant consular courts originated in Italy around 1150 and spread all over Europe.”³⁵ It is easy to see here the analogy between these merchant courts and commercial arbitration, as well as the analogy between the law merchant and modern soft law. Subsequently, merchant customs and practices were incorporated into the hard law, such as the common law, used by established court systems.

Toward the last part of the twentieth century, as a truly global market place developed, there has been a development of a new *lex mercatoria* where the global business community creates substantive rules (business usage, customs, and practices or *lex mercatoria*) and controls the adjudication of disputes and the application of the substantive rules through private international commercial arbitration. The new *lex mercatoria* is substantially different from the two earlier versions in that it is more cosmopolitan, more diverse, and created by a wide variety of entities, both private and public:

Soft law displays a peculiar mixture of spontaneous and organized processes; it is based less on the spontaneous coordination of conduct and more frequently created through highly organized hybrid private-public decision making processes. For instance, the “new lex mercatoria” blurs the distinction between private and public as well as between spontaneous and organized processes, developing in the interstices of the relations between intergovernmental agencies and organizations (UNCITRAL, UNIDROIT, IMO) and private, highly organized, bodies (ICC, ILA).³⁶

However, much of the *lex mercatoria* remains a matter of soft law. The *lex mercatoria* is a source of law that fits well in the more informal rules of evidence and the varied expertise found in arbitration panels.³⁷ Commercial arbitrators are necessarily more informed on the *lex mercatoria* than trial judges that must deal with a variety of subjects, both commercial and noncommercial. The more enlightened legal systems, such as Germany, recognized the special expertise needed to fairly judge commercial contract disputes and have established commercial courts. Karl Llewellyn, the Reporter of the American UCC, envisioned the creation of merchant courts to decide commercial disputes, but the drafting committee rejected his idea of independent commercial courts.

The flexible use of different sources of law—hard and soft—by arbitrators is aided and protected by the narrow grounds for appealing an arbitration award. In 2013, the High Court of Australia was asked to overturn an arbitration award “due to an error of law on the face of the award.” The court noted that: “Neither Article 28 of the Model Law [UNCITRAL Model Law on International Commercial Arbitration as adopted as the law of Australia] nor an implied term of an arbitration agreement requires an arbitral award to be correct in law.”³⁸ The court reasoned that the primary directive of the Model Law, as well as the New York Convention, is to enforce foreign

arbitral awards and not to review such awards for errors in the application of law. Furthermore, the *Guide to the UNCITRAL Model Law on International Commercial Arbitration* notes that, under Article 28, an arbitral panel is not required to apply the law chosen by the parties in a manner that a competent court would have applied the law. Simply put, an arbitral tribunal may need to apply the parties' designated law, but it does not need to apply it correctly. The Model Law narrowly limits the reasons for judicial intervention or nonenforcement of arbitral awards. Article 36(1) lists the grounds for vacating an arbitral award as bias and partiality of the arbitrators, the unfairness of the process, and when enforcement of the award "would be contrary to public policy."

Custom Arbitration Clause

A vague, simple arbitration clause is often not worth the paper it's printed on, since issues it does not deal with will likely need to be resolved by an arbitral panel or a court. This is unfortunate since, depending on the complexity of the issues in dispute, the parties can control the costs and duration of the arbitration through a customized arbitration clause. Model arbitration and mediation clauses can help parties begin to draft contract terms that meet their needs. While model arbitration clauses offer a number of specific options, they are not exhaustive and do not include all possible provisions that may need to be considered or may be desirable in particular contracts. Below are examples of model arbitration and mediation clauses.

Model Arbitration Clause for International Contracts

Any dispute, controversy, or claim arising out, relating to, or in connection with, his contract, or the breach, termination or validity of the contract shall be settled through arbitration. The arbitration shall be conducted in accordance with the Rules of Arbitration of the Court of Arbitration of Madrid in effect at the time of the arbitration. The seat of the arbitration shall be Madrid, Spain and shall be conducted in the Spanish language. Three arbitrators, who shall be selected in accordance with the above arbitration rules, shall conduct the arbitration. The arbitral award shall be in writing and shall be final and binding. The award may include costs, including reasonable attorney's fees and disbursements. The award may be entered and enforced in any court having jurisdiction over the parties or their assets.

Model Mediation Clause for International Contracts

If a dispute, controversy, or claim arises out of or relates to this contract, or the breach, termination, or validity thereof, and if either party decides that the dispute cannot be settled through direct negotiations, the parties agree to endeavor to settle the dispute in an amicable manner by mediation pursuant to JAMS International Mediation Rules. If this mediation does not result in a settlement, then the dispute shall be resolved by arbitration pursuant to the arbitration clause in this contract.

The model clauses may be sufficient in most cases, but the parties may need to deal with additional issues like which law should apply to a given dispute, specific discovery rules, or the power of arbitrators to order interim relief. In practice, it is best for the parties to negotiate a custom clause. The additional time spent negotiating and drafting the clause will be well spent given the costs of international dispute resolution. Figure 4.5 *Focus on Transactions*: "Issues in Drafting a Custom Arbitration Clause" lists a number of issues that should be addressed in negotiating a custom arbitration clause.

Additional matters to be considered for inclusion in the arbitration clause include (1) interim or emergency relief, (2) consolidation of claims and claims of other parties, (3) time limitations, and (4) allocation of costs. Some arbitration rules deal specifically with the question of interim relief by allowing the parties to apply to a court for a preliminary injunction, an order of attachment, or other order to preserve the status quo until the arbitrators can decide the case. Most arbitration rules provide that the arbitrators, once selected, may order interim relief.

Arbitration associations have begun revising their rules to provide an arbitration procedure that will allow a party to obtain *emergency measures* and relief. As noted above, in the past, if a party to an arbitration agreement needed

- **Governing Law:** Given the diversity of national legal systems, all international contracts should have a clearly written choice of law clause. The choice of law clause can direct the arbitrator away from any specific national law and require a decision based upon international law or the *lex mercatoria*. Also, the arbitrator may be empowered to grant any remedy that fairness or equity dictates.
- **Escrow Provision:** Given the cost of enforcing judgments and arbitral awards in the international setting, the parties may want to ensure payment by requiring the establishment of an escrow fund. The fund may be established with the arbitration association (AAA, ICC), a law firm, or an independent escrow agent such as a commercial bank.
- **Venue of Arbitration:** A specific city should be named as the place of arbitration. The selection of the city of arbitration rests upon a number of factors, including convenience for parties, availability of qualified arbitrators, location within a country that is a signatory to the New York Convention, and the language of the proceeding.
- **Selection of Arbitrators:** The two types of selection are party-appointed and association-appointed. The parties, especially when only one arbitrator is being used, may delegate the selection to the arbitration association. For a three-person arbitration panel, each party commonly selects one arbitrator from a list provided by the association. The party-selected arbitrators select the third arbitrator jointly.
- **Qualifications of Arbitrators:** The parties may list within their arbitration clause the requirements of the arbitrators to be appointed. In a complicated transaction, such as an intellectual property transfer, the parties may list different qualifications for each arbitrator. For example, the parties could require that one arbitrator be a certified public accountant familiar with the determination of gross and net revenues and the calculation of royalties, the second be an intellectual property attorney who specializes in a specific area of intellectual property law, and the third be a former administrative law judge or governmental regulatory official with expertise in the regulatory side of intellectual property protection or someone in the computer or technology transfer business.
- **Discovery:** Most arbitration rules minimize the amount of discovery allowed. Depending on the complexity of the claims and sensitivity of the information, the parties may want to provide for discovery. The contract should specify as to what type of discovery is permitted. The clause should limit the time available for discovery in order to avoid the dangers of creating a litigation-type of arbitration. The clause may, for example, provide for discovery under the United States Federal Rules of Civil Procedure, but limit the discovery period to 120 days. Another option is to have the issue be determined under the 2010 International Bar Association's Rules on Taking Evidence in International Arbitration. The IBA Rules blend both the civil and common law approaches to the taking of evidence.
- **Remedies:** The parties may elect to restrict the type and amount of damages to be awarded through arbitration. For example, they may prohibit punitive damage awards or limit the amount of consequential damages.
- **Reasoned Awards:** Most arbitration rules do not require the arbitrators to itemize awards or to give reasons for their decision, but a reasoned award may offer future guidance for the parties. Therefore, the arbitration clause should require an itemized or reasoned award; it should state that the "award shall be in writing and shall specify all findings of fact and conclusions of law."

Figure 4.5 Focus on Transactions: Issues in Drafting a Custom Arbitration Clause.

interim relief, such as an injunction to prevent someone from infringing on its IP rights or a cease and desist order to prevent property subject to the arbitration from being sold, it would have to go to a court to get such orders. The trend, however, is to have the arbitration association provide emergency arbitrators to grant such relief before the actual arbitration panel (that will decide the dispute) is established. For example, the ICC Arbitration Rules, effective January 2012, provide rules for the appointment of emergency arbitrators to consider granting such relief before the arbitration panel is assembled that will hear the dispute.

If there are more than two parties to the contract, or if the parties are entering into several related contracts, they may wish to consider including a provision that any arbitrations among them or with respect to the related contracts will be consolidated into a single proceeding. The drafting of a consolidation clause is very difficult, and expert advice should be sought for assistance in drafting it.

Most national laws regulate specific time limits within which claims must be initiated. The parties may also wish to consider whether a specific time limit should be placed on length of the arbitration proceeding. The parties should check with the appropriate arbitration institution to determine what a reasonable timetable would be.

The rules of various arbitration institutions and ad hoc rules vary with respect to who will pay for the costs of the arbitration, including attorneys' fees. Usually, however, the rules provide that the question of who will bear these costs is within the discretion of the arbitral tribunal. The parties may wish to consider whether they want to include a provision specifying how costs and expenses, including attorneys' fees, shall be apportioned in any arbitration.

The downside of a detailed arbitration clause is that it may be poorly written and cause confusion as well as costly to negotiate. An arbitration clause need not be lengthy or complicated to be effective. A lengthy clause specifying too many procedures may limit the flexibility of the parties and the arbitrators in conducting the arbitration in the most efficient way possible. As arbitration is always based on an agreement to arbitrate, the parties should think about the nature of the disputes that might arise. Discussing the matters together, at the time of contract drafting, could save time resolving the matter if a dispute later arises. The best approach is to start with a standard clause and then customize it based upon a checklist of common issues with straightforward and simple answers to each issue on the checklist. Table 4.3 provides an example of a simple checklist.

An arbitration clause should state the specific rules to be applied, such as the rules of the ICC or the AAA. The AAA's standard clause states: "Any controversy or claim arising out of or relating to this contract shall be settled by arbitration administered by the American Arbitration Association in accordance with its applicable rules and judgment may be entered in any court having jurisdiction thereof." This clause makes clear that *all* issues pertaining to the contract are to be arbitrated, and it provides a complete set of rules and procedures in referencing the AAA rules of arbitration. The *entry of judgment* language ("may be entered in any court") is essential to show intent that any arbitration award is to be final and binding.

The AAA standard clause does not provide for mediation or conciliation as a means to resolve a dispute before a formal arbitration. It is highly recommended that a **med-arb clause** or multistep clause that allows for various methods of alternative dispute resolutions (mediation/conciliation, mini-trials, arbitration) be utilized in most contracts. Conciliation or mediation as a required precursor to any arbitration is generally advantageous to both parties. First, mediation has been shown to be highly successful in resolving disputes promptly and preserving the long-term solidarity of the contractual relationship. Second, if mediation is unsuccessful, the parties will have a better understanding of the issues in dispute, which is likely to lead to a more efficient arbitration. Mediation may be more appealing if the clause states that the arbitrators may include mediation costs in their arbitration award. The downside of mediation is minimal, since either party retains the power to end the mediation at any time in order to proceed to arbitration.

The standard arbitration clause above can be transformed easily into a med-arb clause by inserting the following language: "The parties agree first to attempt to settle the dispute through mediation administered by the AAA and its Commercial Mediation Rules or ICC Rules of Optional Conciliation before resorting to arbitration." Conciliation makes especial sense in an international business dispute because of the increased chance that misunderstandings are due to cultural and language differences. Unfortunately, international mediation or conciliation is an underutilized dispute resolution device. Therefore, it is recommended that the arbitration clause state expressly that the parties have agreed to submit voluntarily to conciliation before they proceed with a formal arbitration.

In order to stimulate interest in conciliation, the ICC updated its Conciliation Rules on January 1, 1988. The ICC Rules of Optional Conciliation, discussed in the next section, are made up of 11 concise articles intended to encourage simplicity, flexibility, timeliness, cost-savings, and confidentiality in the conciliation process.

ICC Rules of Optional Conciliation

The ICC Rules of Optional Conciliation simplify the process of beginning conciliation. The parties simply submit an application for conciliation, along with a \$500 application fee. The Secretary General of the ICC appoints a single conciliator. The conciliator then sets a time period for the parties to present their arguments. Flexibility is enhanced by the fact that the Rules place few restraints upon the conciliator. For example, the conciliator may or may not make settlement recommendations and, unlike in arbitration, may meet individually with either party. The ICC's position regarding costs is that they should be considerably less than the costs of arbitration. The ICC Schedule of Conciliation and Arbitration Costs fixes administrative expenses for conciliation at one-quarter of the amount of arbitration.

Concerns for confidentiality are emphasized in the rules' general mandate that the "confidential nature of the conciliation process shall be respected by every person." Use of the following conciliation-generated information

Table 4.3 Arbitration Clause Checklist with Suggested Answers

<i>Issue</i>	<i>Answer</i>
How many arbitrators should be required?	Three
What should be the characteristics of the arbitrators?	Characteristics should vary depending on the type of contract and subject of a contract. The goal is to select a blend of arbitrators, often with different areas of expertise. The arbitrators need not all be lawyers. For example, in a complicated IPR dispute, the panel may include a lawyer who is a specialist in IPR law, an accountant expert in calculating damages and royalties, and, possibly a businessperson in IPR licensing.
What is the language of the arbitration?	Subject to Negotiations Common Language: English Second Common Language: Spanish
Should the arbitration panel be required to give a reasoned opinion?	Yes The award should state the arbitrators' findings of fact and the reasons for their decision.
What is the location of the arbitration?	Subject to Negotiations
Should there be a period of "discovery" allowed to each party prior to the arbitration hearing?	Yes Depends on the complexity of the arbitration and the amount of money in dispute. Generally, no more than four months.
What discovery rules should be used?	Subject to Negotiations Options include the U.S. Federal Rules of Civil Procedure and Rules of Evidence; International Bar Association's Rules for Taking Evidence.
Should a time (duration) of the arbitration be fixed?	Depends on the complexity of the issues to be arbitrated. If a speedy arbitration is appropriate, then may consider Fast-Track Procedure provided under Article 38 of the ICC Rules.
Should the parties give the arbitrators the power to grant "interim relief," such as orders not to destroy evidence or injunctions not to sell the goods in dispute to a third party?	Yes The alternative is to have to go for a court order, which is likely to be more costly and take more time. Numerous arbitration rules have been amended to allow the appointment of an "Emergency Arbitrator" for the purpose of issuing such orders.
Should the arbitrators be given the power as to what issues they have jurisdiction to hear (scope of the arbitration)?	Yes Unless there are specific issues, such as tort claims, that the parties want to "carve out" of the arbitration clause to be decided by a court, it is best to have the arbitrators determine scope due to the cost of litigating over the issue in court. Arbitration rules and national laws may differ on whether the arbitrators or the courts have the power to determine the scope of the arbitration.
Should the amount of damages be limited?	Subject to Negotiations Sometimes the parties will negotiate high-low amounts of damages to be awarded.

in a subsequent arbitration or court proceeding is specifically prohibited: (1) any views expressed or suggested by any party with regard to a possible settlement, (2) any proposals enunciated by the conciliator, and (3) the fact that one of the parties was agreeable to the conciliator's recommendations. An alternative method is found in the ICC Mediation Rules, which came into force on January 1, 2014. These Rules provide a flexible procedure aimed at achieving a negotiated settlement with the help of a neutral facilitator.

Legality of Arbitration and Forum Selection Clauses

A well-written arbitration clause will answer not only the question of how a contract dispute is to be resolved, but also where the dispute is to be resolved. In the latter sense, an arbitration clause acts as a forum selection clause.

In the past, U.S. courts often voided forum selection clauses as usurping the court's jurisdiction. One of the public policy concerns was to preserve the U.S. plaintiff's right to bring a lawsuit in a U.S. court. The United States Supreme Court in the *Bremen v. Zapata Off-Shore Co.*³⁹ case held that a forum selection clause should be voided only in unusual cases. The court determined that forum selection clauses are to be enforced fully unless the attacking party meets "the heavy burden of showing that its enforcement would be unreasonable, unfair, or unjust." The court explained that the challenging party needed to show that the "contractual forum will be so gravely difficult and inconvenient" that the plaintiff will, for all practical purposes, be deprived of her right to proceed with her claim. The court's stated rationale was that the expansion of U.S. business would be retarded if "we insist on a parochial concept that all disputes must be resolved under our law and in our courts." Furthermore, it reasoned that the security and predictability of international contracts and contract dispute resolution must be ensured. "The elimination of uncertainties by agreeing in advance on a forum acceptable to both parties is an indispensable element in international trade and contracting." The *Tennessee Imports, Inc.* case explores the issues of the arbitrability of specific issues and the enforceability of arbitration clauses.

In the area of consumer purchases, some courts continue to void arbitration clauses. In a 1999 case, a New York court voided an arbitration clause as unconscionable under Section 2-302 of the UCC. *Brower v. Gateway*⁴⁰ involved the sale of a Gateway computer. After receiving an order either by mail, phone, or Internet, Gateway mails its "Standard Terms and Conditions of Agreement." The Standard Terms state that any dispute will be resolved under the arbitration rules of the ICC. The court in *Brower* held that the high cost of arbitration would unconscionably deter the purchaser from invoking a claim.

In contrast, arbitration is accepted without question in most international business settings. The court in *Europcar Italia, S.p.A. v. Maiellano Tours, Inc.*⁴¹ held that any party to a foreign arbitration award can seek

Tennessee Imports, Inc. v. Pier Paulo Filippi and Prix Italia S.R.L.

745 F. Supp. 1314 (Mid D. Tenn. 1990)

Nixon, District Judge. Plaintiff, Tennessee Imports, Inc., brought this action for breach of contract and tortious interference with contract against defendant Prix Italia an Italian corporation with its principal place of business in Venice, Italy. The contract provided that "should any dispute arise between the contractual parties or in connection with the relations stipulated by this contract and no settlement can be achieved, then both parties agree to the competence of the Arbitration Court of the Chamber of Commerce in Venice, Italy." Tennessee Imports argued that enforcement of this provision would result in substantial inconvenience and would deny it effective relief. Furthermore, that the tortious interference claim is not within the scope of the forum selection clause. The defendants have responded to the plaintiff's arguments as follows: (1) that the Arbitration Court referred to in Article 8 is the Arbitration Court of the International Chamber of Commerce, a well-recognized and competent arbitral body which may conduct proceedings in Venice, (2) that the contract between Prix and Tennessee Imports was the result of "arms length negotiations by experienced and sophisticated business entities."

A. The Federal Arbitration Act

Since the forum selection clause at issue is also an arbitration clause, the court found its validity, interpretation, and enforcement are governed by the Federal Arbitration Act, 9 U.S.C. § 1 et seq. Congress enacted the Arbitration Act in 1924 "to ensure judicial enforcement of privately made agreements to arbitrate." The Act sets up "a presumption in favor of arbitration," and requires that courts "rigorously enforce agreements to arbitrate." In the field of international commerce, this presumption in favor of arbitration was strengthened by adoption of the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention or Convention). The United States ratified the Convention on September 30, 1970, with the reservation that: "The United States of America will apply the Convention, on the basis of reciprocity, to the recognition and enforcement of only those awards made in the territory of another Contracting State." Italy is also a member of the Convention.

The language of the Convention contemplates a very limited inquiry by the courts in determining the enforceability of arbitration clauses found in international

commercial agreements. In making this determination, the Court must first address three questions: (1) Is there an agreement in writing to arbitrate the subject of the dispute? (2) Does the agreement provide for arbitration in the territory of a signatory country? (3) Does the agreement arise out of a legal relationship, whether contractual or not, which is considered as commercial? In the case of *narrow arbitration clauses*, the court will determine if issues fall within the scope of an arbitration clause before referring them to arbitration.

In the case of *broad arbitration clauses*, arbitrability of issues falls within the scope of the clause and it will be left to the arbitrators to determine whether an issue falls within the scope of a clause. A court may issue a preliminary injunction if it deems preliminary injunctive relief necessary to ensure that the arbitration process remains a meaningful one.

B. Enforceability of the Arbitration Clause

The sales contract contains an express agreement to arbitrate and provides for arbitration in Italy. Thus, if the disputes between these parties fall within the scope of their arbitration agreement, this Court must enforce that agreement unless the party tortiously induced a breach. Tennessee Imports cannot escape arbitration merely by characterizing these claims as sounding in tort. Courts have consistently held that broad arbitration clauses encompass contract-based tort claims.

Tennessee Imports argues that Prix used its superior economic power to obtain the arbitration clause and, as

such, it is unconscionable. The Uniform Commercial Code addresses the subject of unconscionability in §2-302. It requires that the clause be so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract and “not of disturbance of allocation of risks because of superior bargaining power.” The arbitration clause in this case was not hidden in the small print boilerplate of a standard form contract. Tennessee Imports appears to have had ample opportunity to examine the contract before executing it. Having made its choice, Tennessee Imports must now abide by it.

The parties are hereby REFERRED to arbitration.

Case Highlights

- Arbitration clauses that state the place for arbitration also serve as forum selection clauses.
- In a case involving a “narrow” arbitration clause, the court will determine if issues fall within the scope of an arbitration clause before referring them to arbitration.
- In case of “broad” arbitration clauses, the arbitrators will generally determine the arbitrability of an issue.
- Courts may issue a preliminary injunction if it deems preliminary injunctive relief necessary to ensure that the arbitration process remains a meaningful one.
- Courts are not receptive to attacks on the enforceability of an arbitration clause on ground of unconscionability, especially when both parties are merchants.

confirmation in a U.S. court within three years after the award was made.⁴² The case involved the enforcement of an award made through an informal procedure in Italy. The United States Circuit Court held that “in light of the differences in arbitration among the signatory countries, the New York Convention should be read broadly to cover both formal and informal arbitration. A stay of confirmation should not be lightly granted lest it encourage abusive tactics by the party that lost in arbitration.”⁴³

Challenging an Arbitration Award

Arbitration awards are considered to be “final and binding.” Rarely will a court overturn an arbitration award based upon the merits of the case. The fact that the arbitrators misinterpreted the evidence or made the “wrong” decision is not grounds to appeal the arbitration award. However, there are grounds based upon the process or procedure of the arbitration that can lead to a judicial review and reversal of arbitration awards. A challenge to the award can be based on the claim that the arbitrators were not independent or impartial. IBA Guidelines on Conflicts of Interest in International Arbitration adopts both a subjective and objective test for impartiality/independence. The subjective test requires an arbitrator to voluntarily withdraw if she has any doubt as to her impartiality. The objective test looks at the facts surrounding the arbitration to see if there is an appearance of impropriety. The test is whether the circumstances involving the arbitrator and the dispute raise justifiable doubt

as to the independence of the arbitrator. Note that there need not be an actual conflict of interest, but only the appearance of potential conflict.⁴⁴

Other grounds, besides arbitrator neutrality, for challenging an arbitration award include: (1) the **arbitration tribunal or panel had no jurisdiction** over the dispute or a particular issue in the dispute. There are laws and matters of public policy that void the application of the clause in some instances. For example, the *EU Directive on Unfair Contract Terms in Consumer Contracts* voids arbitration clauses in consumer contracts; (2) the arbitration panel **failed to give fair notice or an opportunity to be heard** to one of the parties; (3) the arbitration panel **did not allow the admission of credible and important evidence**; (4) the **arbitration agreement was not valid**; (5) the **arbitration panel did not follow the instructions** provided in the arbitration clause; or (6) the **subject matter of the dispute was not within the scope of the arbitration clause**. However, these challenges should be made before the beginning of the arbitration and not after its conclusion. Many courts will reject such a challenge after the issuance of the award.

Chapter Summary

- 1 International litigation is generally more complex and costly than is purely domestic litigation. Important issues in international litigation include: determining the court with legal jurisdiction, proper service of process, ability to get discovery of evidence, and the enforceability of judgments. If more than one court has legal jurisdiction over a case, then the proper court may be decided under the *forum non conveniens* doctrine.
- 2 Techniques for ensuring the proper service of the summons and complaint is through dual service or through the Hague Service Convention.
- 3 There are a number of defenses or immunities from litigation provided by a number of laws and common law doctrines, such as the Foreign Sovereign Immunities Act, act-of-state, head-of-state, and diplomatic immunities.
- 4 The American Alien Tort Claims Act allows foreign parties to bring lawsuits against American parties in American courts for certain tort claims, such as human rights violations. Claimants also may sue for foreign acts of torture and extrajudicial killings under the Torture Victim Protection Act.
- 5 The country's law that a court applies to a case will be determined either by a choice of law clause that the parties agreed upon or the court's conflict of laws rules. Judicially or legislatively created conflict of laws rules will determine the applicable law if there is no choice of law clause or the court voids the choice of law as a matter of public policy.
- 6 Arbitration is the most common and preferred means of international dispute resolution. One of the reasons for this is that arbitration awards are easier to enforce than judicial judgments due to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, popularly known as the New York Convention.
- 7 International commercial arbitrations are generally conducted under arbitration rules published by one of the world's highly recognized arbitration associations, such as the International Chamber of Commerce (ICC), American Arbitration Association (AAA), London Court of International Arbitration, China International Economic and Trade Arbitration Commission (CIETAC), and so forth.
- 8 International arbitrators are primarily tasked to render fair and equitable arbitration awards or decisions. As such, they often feel less constrained by applicable law and more willing to use trade usage and business customs, also known as the *lex mercatoria*, in making their decisions. Arbitration awards are final and can only be appealed for a limited number of reasons, such as arbitrator misconduct.
- 9 The arbitration clause is one of the most important clauses in an international contract and should be custom drafted to deal with such issues, as the requirement of a reasoned award, applicable law, language of the arbitration, the amount of discovery permitted, qualifications of the arbitrators, and provisions for emergency measures.
- 10 Under United States law, arbitration clauses are generally enforceable due to the Federal Arbitration Act (FAA).

Key Terms

Act of State	Dual Service	Validity of Foreign
Alien Tort Claims Act (ATCA)	<i>Forum Non Conveniens</i>	Judgments
American Arbitration Association (AAA)	Doctrine	International Chamber of Commerce (ICC)
Brussels Convention	Hague Convention on	Lugano Convention
Choice of Law Clause	International Jurisdiction and	Med-Arb Clause
Conflict of Law Rules	Foreign Judgments in Civil and	New York Convention
Discovery	Commercial Matters	Personal Jurisdiction
Doctrine of <i>Renvoi</i>	Hague Evidence Convention	Rule of Reciprocity
Doctrine of Sovereign Immunity	Hague Service Convention	Service of Process
	Inter-American Convention on the Extraterritorial	

Chapter Problems

- 1 Abraham Lincoln once gave this advice relating to litigation: “Persuade your neighbors to compromise whenever they can. Point out to them how the nominal winner is often the real loser—in fees, expenses, and waste of time. As a peacemaker the lawyer has a superior opportunity of being a good man.” The Roman philosopher Cicero once admonished that “the litigious spirit is more often found with ignorance than with knowledge of law.” Do you agree with this view of litigation? Do you believe that alternative dispute resolution is adequately used by U.S. business enterprises? What would you recommend for improving the U.S. dispute resolution system?
- 2 Several securities investors who were customers of a broker signed a standard agreement that included a clause requiring the arbitration of any controversies relating to their accounts. When the investments turned sour, the investors sued the broker and the broker’s principal in the United States District Court for the Southern District of Texas under the 1933 Securities Act. The defendant moved that the claims be submitted to arbitration, under the agreement. Should the plaintiffs be forced to arbitrate their federal securities law claims? Does the public policy of full enforcement of the securities laws prevail over the public policy favoring arbitration? *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989).
- 3 Your son has been killed in a car accident in a foreign country. You believe a U.S. agency is withholding information that may provide insight into the cause of the accident. You file a motion to compel the agency to comply with your subpoena requesting certain documents. Will the court compel the agency to comply with the subpoena? Does the notion of sovereign immunity enter into the court’s determination? *In re Application of Mohamed al Fayed*, 92 F.Supp.2d 137 (D.D.C., 2000).
- 4 Pursuant to a request by a foreign court, a legal alien resident of the United States is asked to testify about his activities during World War II and his immigration to the United States. Can he be compelled to testify against himself? Does the Fifth Amendment’s privilege against self-incrimination extend to the fear of being prosecuted by a foreign nation? *United States v. Balsys*, 118 S. Ct. 2218 (1998).
- 5 A U.S. seller and an English purchaser of services enter into a contract for servicing of heavy machinery at the purchaser’s factory. The service contract included an exculpatory clause that relieved the seller of all liability relating to his work. U.S. law generally enforces such clauses, while English law often voids such clauses. The choice of law clause in the contract provided that U.S. law would apply to the contract. Soon after the U.S. seller serviced the machinery, it malfunctioned, injuring two workers and causing substantial property damage to the English company’s factory. The English party brought suit in an English court. The U.S. company sought a dismissal, citing the exculpatory clause. What factors will the English court look at in determining the validity of the choice of law clause as it relates to the issues of this case?

Internet Exercises

- 1 Review the model arbitration and mediation clauses published by the International Chamber of Commerce at http://www.iccwbo.org/index_court.asp.
- 2 Review the index of the 35 international conventions sponsored by the Hague Conference on Private International Law at <http://www.hcch.net/e/conventions/index.html>.

Other Internet Sources

International Bar Association: <http://www.ibanet.org>.

Foreign Sovereign Immunities Act: <http://www.state.gov/documents/organization/153980.pdf>.

Hague Evidence Convention: <http://www.hcch.net/e/conventions/index.html>.

ICC International Court of Arbitration: http://www.iccwbo.org/index_court.asp (ICC rules and model clauses).

American Society of International Law: <http://www.asil.org> (Click on “Topics” and click on “Transnational Litigation, Arbitration, and Dispute Resolution.”)

American Arbitration Association: <http://www.adr.org>.

Notes

- 1 11 U.S. (7 Cranch) 116, 3 L. Ed. 287 (1812).
- 2 See *Banc Nacional de Cuba v. Sabbatino*, 376 U.S. 398 (1964).
- 3 See David Stewart, “Samantar v. Yousuf: Foreign Official Immunity under Common Law,” 14 *ASIL Insights* (June 14, 2014).
- 4 630 F.2d 876 (2d Cir. 1980).
- 5 See Curtis Bradley, “Supreme Court Holds that Alien Tort Statute Does Not Apply to Conduct in Foreign Countries,” 17 *ASIL Insights* (April 18, 2013).
- 6 542 US 692 (2004).
- 7 Torture Victim Protection Act, 106 Stat. 73 (1992), *reprinted in* 28 U.S.C.A. §1350 (1992).
- 8 *Ibid.*
- 9 492 F. Supp. 885 (N.D. Tex. 1980).
- 10 159 U.S. 113 (1895).
- 11 See Robert von Mehren and Michael Patterson, “Recognition and Enforcement of Foreign-Country Judgments in the United States,” 6 *Law & Policy in International Business* 37, 61 (1974).
- 12 Uniform Foreign Money-Judgments Recognition Act, 13 Uniform Laws Annotated (U.L.A.) 263 (1962). Unfortunately, this law is of modest use because it has not been widely adopted.
- 13 §187: Law of the State Chosen by the Parties.
- 14 915 F.2d 1000 (5th Cir. 1990).
- 15 Unfair Contract Terms Act §4(1) (1977).
- 16 Willis Reese, “Conflict of Laws and the Restatement Second,” 28 *Law & Contemporary Problems* 679 (1963).
- 17 Shahla F. Ali, “Approaching the Arbitration Table: Comparing the Advantages of Arbitration as seen by Practitioners in East Asia and the West,” 28 *Review of Litigation* 735, 741–742 (2009).
- 18 *Ibid.* at 759.
- 19 See Robert F. Utter, “Dispute Resolution in China,” 62 *Washington Law Review* 383 (1987) (describing China’s history of using informal dispute resolution mechanisms rather than the courts).
- 20 Ali at 746.
- 21 Steven C. Nelson, “Alternatives to Litigation of International Disputes,” 23 *International Lawyer* 187, 199 (1989).
- 22 Andrew M. Pardieck, “Virtuous Ways and Beautiful Customs: The Role of Alternative Dispute Resolution in Japan,” 11 *Temple International & Comparative Law Journal* 31, 33, 37–42, 44–45, 55 (1997).
- 23 Larry A. DiMatteo, *Principle of Fair and Equitable Decision-Making in International Contract Arbitration and its Affinity to International Soft Law*, 1 *Chinese Journal of Comparative Law* 1 (Oxford University Press 2013). (Material in this section is taken from this article. Footnotes omitted.)
- 24 Michael John Garcia, “International Law and Agreements: Their Effect upon U.S. Law,” Congressional Research Service, (March 1, 2013), No. 7-5700, *available at* www.crs.gov.

- 25 See DiMatteo, footnote 23.
- 26 Ahmad Alkhamees, “International Arbitration and Shari’a Law: Context, Scope, and Intersections,” 28 *Journal of International Arbitration* 255, 261 (2011).
- 27 Charles Trumbull, “Islamic Arbitration: A New Path for Interpreting Islamic Legal Contracts,” 59 *Vanderbilt Law Review* 609 (2006).
- 28 See Alkhamees above.
- 29 See Alkhamees above.
- 30 See Alkhamees above.
- 31 Lisa Spagnolo, “CISG as Soft Law and Choice of Law” in *International Sales Law: A Global Challenge* (ed. Larry A. DiMatteo, Cambridge University Press: New York 2013).
- 32 Harold J. Berman and Colin Kaufman, “The Law of International Commercial Transactions (Lex Mercatoria),” 19 *Harvard International Law Journal* 221 (1978).
- 33 Anna Di Robilant, “Genealogies of Soft Law” 54 *The American Journal of Comparative Law* 499, 518–519 (2006).
- 34 *Ibid.* at 519.
- 35 *Ibid.* at 520.
- 36 *Ibid.* at 524.
- 37 Ole Lando, “The Lex Mercatoria in International Commercial Arbitration,” 34 *ICLQ* 747 (1985).
- 38 *TCL Air Conditioner (Zhongshan) Co. Ltd. v. The Judges of the Federal Court of Australia* [2013] HCA 5 (March 13, 2013).
- 39 407 U.S. 1 (1971).
- 40 676 N.Y.S.2d 569 (App. Div. 1999).
- 41 Docket No. 97-7224 (2d Cir. 1997).
- 42 9 U.S.C. §207.
- 43 3 F.3d 576 (1993).
- 44 Margaret L. Moses, *International Commercial Arbitration* 137 (2nd ed. 2012).



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Part II

TRADE REGULATION



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INTERNATIONAL TRADE REGULATION

This chapter is the first of two covering international and governmental regulation of international trade. We will first look at the world trading system as it has evolved under the **General Agreement on Tariffs and Trade (GATT)**. The postwar success of GATT has led to the establishment of a permanent international institution known as the **World Trade Organization (WTO)**. The primary purpose of the WTO is to remove barriers to international trade. Chapter 5 will review the WTO and the agreements it has been empowered to enforce. International trade has also been affected by the development of strong regional trading blocs. The **European Union (EU)** and the **North American Free Trade Agreement (NAFTA)** are two of the more successful attempts at regional trade integration. NAFTA will be discussed in Chapter 6 on “National Import and Export Regulation” and Chapter 7 on “Free Trade Agreements.” Chapter 8 will review the legal tenets that are the foundation of the European Union.

Free Trade Era: The modern free trade era began in the late 1940s with the U.S. and United Kingdom’s push for a world trade organization to prevent the protectionism (high tariffs and quota restrictions) that existed before and during the Great Depression. GATT was established in 1948, and over a 60-year period it succeeded in cutting average tariffs in the developed world from 40 percent to 4 percent.

Extending the coverage of trade regulation to the national level, Chapter 6 will examine the relationship between national trade regulation and the world trading system, particularly import and export regulations. Chapter 6 reviews national import requirements, the assessment of tariff duties (“taxes” or fees levied on imported goods), country of origin rules, marking requirements, and national standards regulations, as well as the U.S. export regulation system.

WTO and the World Trading System

The WTO currently has 162 member countries (see Figure 5.1: “WTO Member Countries”) that make up 96.7 percent of world GDP, with Russia being the last major trading country to obtain membership in 2012. The economic theory that underlies the WTO system is the **theory of comparative advantage** espoused by economist David Ricardo in the early nineteenth century in *On the Principles of Political Economy and Taxation* in 1817. Ricardo’s theory was an international version of Adam Smith’s idea of the “specialization of labor” as espoused in his 1776 book, *An Inquiry into the Nature and Causes of the Wealth of Nations*, in which Smith has been credited for being the father of the discipline of economics.

Put simply, economic growth can be obtained by allowing people to do the things they are best at doing and then trading or buying goods and services that are provided by other specialists. This is the rationale behind the widely accepted view that free trade or the removal of artificial obstacles (tariffs and quotas) to trade between nations will lead to overall economic growth to the benefit all nations. If national industries are not protected through government subsidies or the assessment of excessive tariffs on imported goods, then nations will restructure to produce



Image 5.1 David Ricardo (1772–1823).

what they are best at producing. This allows them to export their surpluses and be able to more cheaply purchase imports of goods they are not efficient at producing.

The map in Figure 5.1 shows 159 of the 162 member countries of the WTO. Tajikistan and Laos joined in 2013. Since then, Yemen joined in 2014 and Seychelles in 2015. The two largest economies that remain nonmembers are Iran and Algeria.

GATT System

Before the establishment of the WTO, the multilateral trading system was known as GATT. The initial aim of GATT was to expand free trade through the reduction of tariffs worldwide. Following GATT's creation in 1948, there were seven *rounds* of GATT negotiation, beginning with the Annecy Round in 1949 and culminating with the **Uruguay Round** in 1994, which established the WTO. The WTO replaced the ad hoc nature of the system of *rounds* of negotiations with a permanent institution. Major negotiations among WTO member countries are still called rounds but are held under the auspices of the WTO.

GATT's greatest success was in reducing tariffs assessed on imported goods. High tariffs had been the major obstacle to international trade. High tariff rates were one of the major factors that led to the length of the Great Depression. The U.S. Smoot-Hawley Act of 1930 raised tariffs in the range of 50 to 100 percent. Following World War II, at a 1947 meeting in Geneva, the major powers established the GATT framework with the goal of reducing tariffs worldwide. The economic benefits of eliminating tariffs is shown in Figure 5.2: "Theory of Free Trade."

Figure 5.2 shows the effect of placing a tariff on an imported good. Before the assessment of the tariff, the price of the good in the market is P_{world} . The price rises due to the tariff to P_{tariff} . The higher price causes domestic production to rise from Q_{S1} to Q_{S2} , thereby reducing demand from Q_{C1} to Q_{C2} . In this scenario, consumers are worse off because the consumer surplus area becomes smaller, while the producer surplus becomes larger and then gains additional tax revenues. However, the loss to consumers $>$ gains by producers + government revenues. The net societal loss is shown by the two triangles. Thus, in a world of tariffs, the reduction of tariffs results in a net gain for society.¹



Figure 5.1 WTO Member Countries.

Source: Wikimedia Commons.

Under GATT, when countries agree to open their markets they are required to bind their commitments. In the area of tariffs, bindings amount to placing ceilings upon tariff rates. Countries may reduce their tariff rates below the bound rates but may not exceed the bound rates. The Uruguay Round dramatically increased the amount of trade covered by **binding commitments**. The percentages of goods that had bounded tariff rates before 1986 and at the end of the Uruguay Round increased from 78 percent to 99 percent for developed countries, from 73 percent to 98 percent for transitional countries, and from 21 percent to 73 percent for developing countries. As a result, modern tariff rates are generally in the range of 4–5 percent, and in the case of free trade agreements as low as 0 percent. The lowering of tariff rates has resulted in a tremendous increase in market stability and security.

The Uruguay Round not only established the WTO, but also included a package of agreements expanding for the first time into nontariff areas such as illegal government subsidies of domestic industries, obstacles to sales of services, and infringement of intellectual property rights. The U.S. Department of Commerce defines trade barriers to include not only tariffs, but also quantitative restrictions, import licensing, and customs barriers; standards, testing, labeling, and certification; government procurement, export subsidies, service barriers, lack of intellectual property protection, and investment barriers. The package of WTO Agreements covers all these types of trade barriers. The WTO agreements include the **General Agreement on Trade in Services (GATS)** (see Chapter 16) and the **Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)** (see Chapter 18).

Despite the liberalization of the world trading system through GATT and the WTO, major areas of dispute remain. The conclusion of the *Doha Round* was delayed due to a division between “North” (developed) and “South” (less developed) countries. In 2001, the *Doha Round* was convened but ultimately failed due to this North–South rift. However, an agreement was reached, known as the **Bali Package**, in December 2013. The Agreement focuses on reducing import tariffs and agricultural subsidies, with the goal of making it easier for developing countries to trade in global markets. The developed countries agreed to eliminate or abolish import quotas on agricultural products from the developing world. Another important target of the Bali agreement is reforming customs bureaucracies and formalities to facilitate trade. It has been estimated that if the

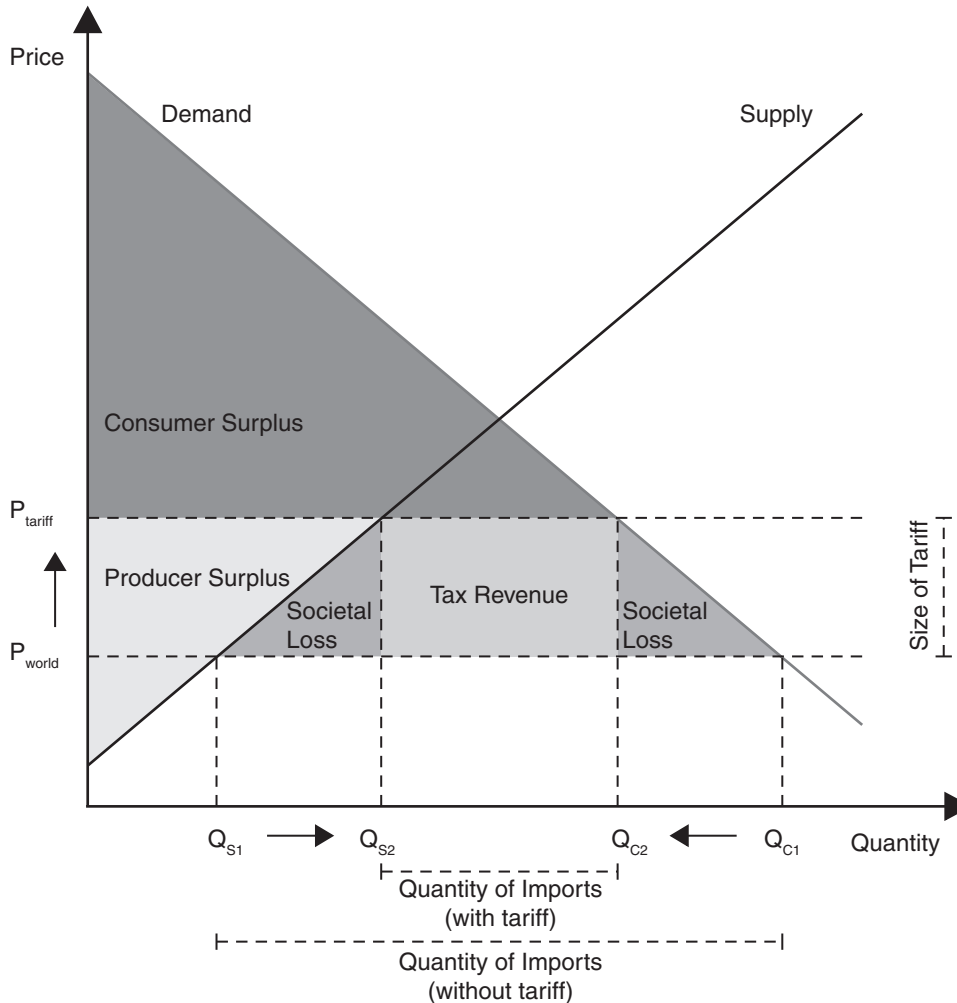


Figure 5.2 Theory of Free Trade.

(Disadvantage of Tariffs).

Bali Package is fully implemented it would result in a \$1 trillion growth in international trade and the creation of 21 million new jobs.²

WTO Principles

Although the 1994 WTO Agreements created the WTO, it should be noted that the multilateral agreements, known as GATT, that preceded the WTO, remain in force unless subsequently amended. Therefore, references to provisions in GATT are still used. The WTO is the governing authority and enforcer of the GATT agreements. The WTO international trade regime is based on three fundamental GATT principles: (1) most-favored-nation principle, (2) national treatment principle, and (3) the principle of transparency. All three are aimed at advancing the notion of nondiscrimination by which countries are mandated not to discriminate among different foreign trading partners or between domestic goods and imported goods.

The **most-favored-nation principle** is one of the means of reducing tariff rates internationally. If two countries negotiate a lower tariff rate between themselves, they must also provide the lower rate to all other WTO countries. If a country grants benefits to a trading partner through a bilateral agreement, then it must also grant those benefits to all other members of the WTO. Thus, when a country lowers a trade barrier or opens up a domestic market it has to do so for all its trading partners. The exception to this rule are **free trade agreements (FTAs)**, which allow two or more countries to form a free trade area, such as NAFTA or a customs union, such as the EU, that allows the area or union to be treated as a single country for purposes of complying with the most-favored-nation principle. Thus, the charging of lower (preferential) tariffs to countries within an FTA would not be in violation of WTO rules. Article XXIV of GATT provides:

The Contracting Parties (WTO countries) recognize the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries' parties to such agreements. They also recognize that the purpose of a customs union or of a free trade area should be to facilitate trade between countries and not to raise barriers to the trade of other WTO countries.

There are currently about 300 FTAs in the world. FTAs will be discussed in depth in Chapter 7.

The **national treatment principle** prohibits the discrimination between imported goods and domestically produced goods. Article III of GATT provides that imported goods cannot be subjected to direct or indirect taxes or charges in excess to those charged on domestic products. Article III further states that imported goods shall be accorded treatment "no less favorable than that accorded to like products of national origin." The national treatment principle applies once goods enter a foreign market. Once a product, intellectual property right, or service enters a foreign market it must receive the same treatment given to domestically produced goods, services, and intellectual property rights even though it can be treated differently at the time of importation. Therefore, charging customs duties on imported goods is not a violation of the national treatment principle. Import requirements that are disguised trade barriers would be subject to attack as a violation of the national treatment principle. For example, requiring foreign goods to satisfy higher standards or to pass more rigorous testing or inspections than domestic goods would be illegal. The *Warren Corp. v. EPA* case that follows illustrates the fact that international obligations as required under GATT may conflict with domestic requirements.

George E. Warren Corp. v. U.S. Environmental Protection Agency

164 F.3d 676 (D.C. Cir. 1998)

A rule promulgated by the Environmental Protection Agency (EPA) regulates emissions from conventional gasoline for motor vehicles, and changes the way importers and foreign refiners of conventional gasoline sold in the U.S. had been treated under the prior rule. In 1994 the EPA announced standards for setting individual baselines under which domestic refiners, foreign refiners, and importers were all treated differently. Domestic refiners were allowed to establish individual baselines because the EPA determined they had adequate and reliable data with which to do so. Each importer was permitted to establish an individual baseline, but because they generally lacked the data to do so, importers were in practice assigned the statutory baseline.

The World Trade Organization (WTO) held the rule violated the antidiscrimination norm of GATT because domestic refiners were allowed to set individual baselines while foreign refiners were not. The United States Trade Representative advised the WTO that the U.S. intended to comply with that decision. The EPA proposed to adopt the optional baseline approach, allowing each foreign refiner either to accept the statutory baseline or to petition the EPA for permission to establish an individual baseline. The petitioners, a number of U.S. companies, challenged the legality of this 1997 rule.

The petitioners argue that the EPA may not consider factors other than air quality. The EPA responded that nothing in the statute precludes consideration of such

factors, and that its approach is congruent with that employed by the Congress when it enacted the anti-dumping provision. We think the agency's interpretation is permissible. There is a fundamental distinction between EPA's ability to monitor and enforce regulatory requirements that would apply against domestic as opposed to foreign refiners. Simply put, domestic refiners are subject to the full panoply of EPA's regulatory jurisdiction and compliance monitoring, while not all foreign refiners desiring to produce gasoline may be subject to EPA's regulatory jurisdiction with equivalent certainty. Accordingly, the petitions for review are DENIED.

Case Highlights

- WTO's national treatment principle requires that individuals and firms of foreign countries are given the same competitive opportunities, including market access, as are available to domestic parties.
- International agreements prevail over conflicting national statutory mandates.
- Federal regulatory agencies may weigh different factors (such as international commitments) when rendering a decision or applying a regulation to a situation with international ramifications as opposed to a purely domestic one.

The **principle of transparency** requires WTO countries to make their import and custom laws accessible to importing parties. Furthermore, import regulations should be stable and clear so that importing parties will not be confused as to the requirements for importation. Most WTO agreements require governments to fully disclose import policies and practices publicly, and changes to such policies and practices require formal notification of the WTO. Disguised barriers to trade, such as unsubstantiated quality and health restrictions, often violate both the national treatment and transparency principles. See Figure 5.3 *Doing Business Internationally*: "Menu of WTO Principles."

Critics of the WTO have argued that the WTO has failed to sufficiently address the last two principles: "more beneficial for less developed countries" and "protect the environment." The collapse of the Doha Round, mentioned earlier, is symbolic of the less developed countries' sense of frustration with the slow progress of their economic development. The criticism of the WTO in the area of environmental protection is discussed later in the chapter.

<p>Non-Discrimination</p> <p>A country should not discriminate between its trading partners and it should not discriminate between its own and foreign products, services or nationals.</p> <p>Open Access</p> <p>Lowering trade barriers is one of the most obvious ways of encouraging trade; these barriers include customs duties (or tariffs) and measures such as import bans or quotas that restrict quantities selectively.</p> <p>Predictable and Transparent</p> <p>Foreign companies, investors and governments should be confident that trade barriers should not be raised arbitrarily. With stability and predictability, investment is encouraged, jobs are created and consumers can fully enjoy the benefits of competition—choice and lower prices.</p> <p>More Competitive</p> <p>Discouraging "unfair" practices, such as export subsidies and dumping products at below cost to gain market share; the issues</p>	<p>are complex, and the rules try to establish what is fair or unfair, and how governments can respond, in particular by charging additional import duties calculated to compensate for damage caused by unfair trade.</p> <p>More Beneficial for Less Developed Countries</p> <p>Giving them more time to adjust, greater flexibility and special privileges; over three-quarters of WTO members are developing countries and countries in transition to market economies. The WTO agreements give them transition periods to adjust to the more unfamiliar and, perhaps, difficult WTO provisions.</p> <p>Protect the Environment</p> <p>The WTO's agreements permit members to take measures to protect not only the environment but also public health, animal health and plant health. However, these measures must be applied in the same way to both national and foreign businesses. In other words, members must not use environmental protection measures as a means of disguising protectionist policies.</p>
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Figure 5.3 *Doing Business Internationally*: Menu of WTO Principles.

WTO Agreements

The 1980s and 1990s witnessed a tremendous liberalization of international trade law. The breadth of trade liberalization was evident in the successful conclusion of the Uruguay Round of GATT. The expansion beyond GATT's traditional mandate of tariff reduction shows how pervasive the free trade movement has become. The foundational document establishing the WTO was the Agreement Establishing the World Trade Organization. Annexes to the Agreement include a long list of side agreements on investment, services, technology protection, and government procurement. Together the package of agreements is referred to as the "WTO Agreements." A number of the Agreements, mostly of a technical nature, of immediate importance to international exporters and importers include:

- Agreement on the Application of Sanitary and Phytosanitary Measures;
- Agreement on Technical Barriers to Trade;
- Customs Valuation Code;
- Agreement on Preshipment Inspection;
- Agreement on Rules of Origin;
- Agreement on Import Licensing Procedures;
- Agreement on Government Procurement.

The Agreement on the Application of Sanitary and Phytosanitary Measures (SPS) and the Agreement on Technical Barriers to Trade (TBT) will be discussed later in this chapter. Other major side agreements that will be discussed in this book include: General Agreement on Trade in Services (GATS) (Chapter 16), Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) (Chapter 18), and Agreement on Trade-Related Investment Measures (TRIMs) (Chapter 20).

WTO and the Importation of "Illegal" Goods

A country, under WTO rules, can raise barriers to the importation of goods from specific countries that have violated the principles of GATT. These punitive barriers are generally enacted in response to the giving of illegal **subsidies** to companies by a foreign government or when an exporter is accused of **dumping** goods on a foreign market. A subsidy is when a government grants a domestic industry some benefit not granted a foreign industry. Dumping is when a foreign company exports and sells goods at below-market prices. Dumping can be proved by evidence that the goods are sold below cost or at a price that is lower than the price the goods are sold at in the exporter's home country. Before enacting any countervailing measures (tariffs), the country that has been victimized must seek WTO permission through the WTO dispute resolution process. The respective cases of both countries are presented to an ad hoc WTO panel, which then renders a decision. If the complainant wins, the panel will sanction a specific remedy, generally a tariff increase for an illegal subsidy or a **countervailing duty** in dumping cases.

Most actions brought under the WTO dispute resolution procedure are anti-dumping cases; fewer involve illegal subsidies, and there are much fewer cases involving **safeguards**. Safeguards involve the granting of exemptions for the violation of GATT principles. Safeguards are authorized under Article XIX of GATT and provide:

If, as a result of unforeseen developments and the effect of the obligations incurred under this Agreement, any product being imported into a [member country] in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers, the [country of import] shall be free to the extent and such time as may be necessary to prevent or remedy such injury.

However, the country of import must prove a causal link between the increase of imports of the product and a serious injury to a domestic industry. The "Agreement on Safeguards" limits the duration of safeguard measures to four years with the possibility of obtaining a four-year renewal if the domestic industry is still being threatened.

The country of import must first consult with the country of export before implementing any measures. Often, the two countries will negotiate compensatory trade concessions.

Sanitary and Phytosanitary Measures Agreement

The **Agreement on the Application of Sanitary and Phytosanitary Measures (SPS)** sets out the basic rules for food safety and animal and plant health standards. For the purposes of the SPS Agreement, sanitary and phytosanitary measures are defined as any measures needed to:

- protect human or animal life from risks arising from additives, contaminants, toxins, or disease-causing organisms in their food;
- protect human life from plant- or animal-carried diseases;
- protect animal or plant life from pests, diseases, or disease-causing organisms; or
- prevent or limit other damage to a country from the entry, establishment, or spread of pests.

Measures for environmental protection (other than as defined above), to protect consumer interests, or for the welfare of animals, are not covered by the SPS Agreement. These concerns are addressed by the **Agreement on Technical Barriers to Trade (TBT)**.

The SPS Agreement allows countries to set their own standards, but it also says regulations must be based on science. The SPS Agreement builds on previous GATT rules to restrict the use of unjustified sanitary and phytosanitary measures for the purpose of trade protection. The basic aim of the SPS Agreement is to maintain the sovereign right of any government to provide the level of health protection it deems appropriate, but to ensure that these sovereign rights are not misused for protectionist purposes and do not result in unnecessary barriers to international trade.

SPS standard should be applied only to the extent necessary to protect human, animal, or plant life or health. They should not arbitrarily or unjustifiably discriminate between countries where identical or similar conditions if its consumers are being supplied with food that is safe to eat—“safe” by the standards the importing country deems to be appropriate. At the same time, how can one ensure that strict health and safety regulations are not being used as an excuse for protecting domestic producers as disguised barriers to trade? One answer to this question is for member countries to use international standards, guidelines, and recommendations where they exist. The next section reviews the key features of the SPS Agreement.

Key Features of SPS

All countries maintain measures to ensure that food is safe for consumers, and to prevent the spread of pests or diseases among animals and plants. These sanitary and phytosanitary measures can take many forms, such as requiring products to come from a disease-free area, inspection of products, specific treatment or processing of products, setting of allowable maximum levels of pesticide residues, or permitted use of only certain additives in food. Sanitary (human and animal health) and phytosanitary (plant health) measures apply to domestically produced food or local animal and plant diseases, as well as to products coming from other countries.

FEAR OF PROTECTIONISM

Sanitary and phytosanitary measures, by their very nature, may result in restrictions on trade. All governments accept the fact that some trade restrictions may be necessary to ensure food safety and animal and plant health protection. However, governments are sometimes pressured to go beyond what is needed for health protection and to use sanitary and phytosanitary restrictions to shield domestic producers from economic competition. A sanitary or phytosanitary restriction, which is not actually required for health reasons, can be a very effective protectionist device, and because of its technical complexity, a particularly deceptive and difficult barrier to challenge.

JUSTIFICATION OF MEASURES

The SPS Agreement requires that sanitary and phytosanitary measures be applied for no other purpose than that of ensuring food safety and animal and plant health. In particular, the Agreement clarifies which factors should be taken into account in the assessment of the risk involved. Measures to ensure food safety and to protect the health of animals and plants should be based as far as possible on the analysis and assessment of objective and accurate scientific data. See the *United States v. India* and *United States v. European Community* cases that follow in which national SPS standards were found in non-compliance with the risk assessment and scientific basis requirements of the SPS Agreement. The key SPS provisions are Articles 2.2 and 5.7:

Article 2.2 of the Agreement on the Application of Sanitary and Phytosanitary Measures provides that: “Members shall ensure that any sanitary or phytosanitary measure is applied only to the extent necessary to protect human, animal, or plant life or health, is based on scientific principles, and is not maintained without *sufficient scientific evidence*.” When relevant scientific evidence is insufficient, “a Member may provisionally adopt sanitary or phytosanitary measures on the basis of available pertinent information. . . . Members shall seek to obtain the additional information necessary for a more objective assessment of risk . . . within a reasonable period of time.”

Article 5.7 states that phytosanitary measures may not arbitrarily or unjustifiably discriminate between member nations where similar conditions prevail and may not constitute *disguised restrictions* on international trade.

As defined in the WTO’s Agreement TBT, a standard is a technical specification contained in a document that specifies the characteristics of a product such as levels of quality, performance, safety, or dimensions. Standards may include terminology, symbols, testing, packaging, marking, or labeling requirements.

SPS mandates that countries not use such measures (safety or technical standard) or restrictions “as disguised devices” to restrict the importation of goods. “Countries are required to accept one another’s measures as equivalent; but the exporting country may need to demonstrate that its measures achieve the importing country’s SPS protection level” including giving the “importing country access for inspection, testing, and similar procedures.”³ The *United States v. India* WTO case shows how national safety measures (SPS standards) can affect trade, especially when they act as disguised restrictions.

International Standards

The SPS Agreement encourages governments to establish national SPS measures consistent with international standards, guidelines, and recommendations. This process is often referred to as “harmonization.” The WTO itself does not and will not develop such standards. However, most of the WTO’s member governments participate in the

United States v. India

WTO Decision on Imports of Poultry and Other Agricultural Products (October 14, 2014)

On 6 March 2012, the U.S. requested consultations with India with respect to the prohibitions imposed by India on the importation of various agricultural products because of India’s concerns related to Avian Influenza (AI). The measures at issue are: the Indian Livestock Importation Act, 1898 (9 of 1898) (Livestock Act); a

number of orders issued by India’s Department of Animal Husbandry, Dairying, and Fisheries; as well as any amendments or implementing measures.

The U.S. claims that the measures are inconsistent with provisions of the SPS Agreement, as well as Articles I and XI of GATT. On 15 March 2012, Colombia requested to join the consultations. On 11 May 2012, the United States requested the establishment of a panel.

Panel and Appellate Body Proceedings

The Dispute Settlement Body (DSB) established a panel on 25 June 2012. Argentina, Australia, Brazil, China, Colombia, Ecuador, the European Union, Guatemala, Japan and Viet Nam reserved their third party rights. On 5 August 2013, the Chair of the panel informed the DSB that the panel expects to issue its final report to the parties no sooner than June 2014.

Summary of Findings

This dispute concerns India's import prohibition affecting certain agricultural products from countries reporting Notifiable Avian Influenza (NAI) to the World Organisation for Animal Health (OIE). This import prohibition is maintained through India's Avian Influenza (AI) measures, namely: (1) Livestock Importation Act 1898 (Livestock Act), as amended by the Livestock Importation (Amendment) Act 2001 (Livestock Amendment Act), and (2) Statutory Order (SO) 1663(E) issued by India's Department of Animal Husbandry, Dairying, and Fisheries (DAHD).

The U.S. complained that India's AI measures amounted to an import prohibition that was not based on the relevant international standard (OIE Terrestrial Code) or on a scientific risk assessment. The U.S. requested the Panel to find that India's AI measures were inconsistent with a number of provisions of the Sanitary and Phytosanitary (SPS) Agreement: (1) Article 2.2 (that SPS measures be applied only to the extent necessary to protect human, animal or plant life or health and the obligation to base these measures upon scientific principles), (2) Article 2.3 (prohibition of arbitrary or unjustifiable discrimination), (3) Article 3.1 (harmonization of SPS measures based on international standards), (4) Articles 5.1 and 5.2 (risk assessment obligations), (5) Article 5.6 (obligation to ensure that SPS measures are not more trade-restrictive than required), (6) Articles 6.1 and 6.2 (adaptation of measures to regional conditions), and (7) Article 7, Annex B (2) and B (5)(a), (b) and (d) (publication, notification and transparency requirements) of the SPS Agreement, as well as Article XI of the GATT 1994 (general elimination of quantitative restrictions). India's main argument in response was that its AI measures "conform to" an international standard (OIE Terrestrial Code) pursuant to Article 3.2 of the SPS Agreement, and that consequently, compliance with other provisions of the SPS Agreement (including those requiring that SPS measures have a scientific foundation) and the GATT 1994 must be presumed. India also submitted to the Panel two separate requests for a preliminary ruling concerning

the consistency of the U.S.'s panel request with Article 6.2 of the DSU (identify specific measures at issue).

As with the majority of SPS cases, the Panel decided to seek advice on certain aspects of the dispute from experts and international organizations. The Panel consulted with the OIE on the interpretation of the OIE Terrestrial Code and with three individual experts on AI surveillance regimes with particular respect to India's domestic measures and its disease situation.

With respect to India's first request for a preliminary ruling, the Panel issued a preliminary ruling on 22 May 2013 that was circulated to Members on 28 June 2013 and was later incorporated by reference into the Panel's Report. The Panel found, *inter alia*, that: In respect of the U.S.'s claims pursuant to the SPS Agreement, the Panel found as a preliminary matter that India's AI measures are SPS measures within the meaning of Annex A(1) of the SPS Agreement and are subject to the disciplines of the Agreement.

The Panel further found that:

- India's AI measures are inconsistent with Article 3.1 of the SPS Agreement because they are not "based on" the relevant international standard (Chapter 10.4 of the OIE Terrestrial Code);
- India's AI measures are inconsistent with Articles 5.1, 5.2 and 2.2 of the SPS Agreement because they are not based on a risk assessment;
- India's AI measures are inconsistent with Article 2.3 of the SPS Agreement because they arbitrarily and unjustifiably discriminate between Members where identical or similar conditions prevail and are applied in a manner which constitutes a disguised restriction on international trade;
- India's AI measures are inconsistent with Articles 5.6 and 2.2 of the SPS Agreement because they are significantly more trade-restrictive than required to achieve India's appropriate level of protection (ALOP), and therefore are also applied beyond the extent necessary to protect human and animal life or health;
- India's AI measures are inconsistent with Articles 6.2 and 6.1 of the SPS Agreement because they do not recognize the concept of disease-free areas and areas of low disease prevalence, and because they are not adapted to the SPS characteristics of these areas;
- India acted inconsistently with Article 7, Annex B (2) and Annex B (5)(a), (b) and (d) of the SPS Agreement because it failed to comply with a number of notification and publication requirements.

On 26 January 2015, India filed an appeal challenging the findings of the Panel. On 4 June 2015, the Appellate Body issued the following Report:

Findings of the Appellate Body

Finding 1: The Appellate Body (AB) agrees with the Panel. India's AI measures were not based on: (1) a *risk assessment* (Article 2.1), (2) failed to provide evidence that its measures were the minimum needed to protect human, animal or plant life or health, and (3) that such evidence was based upon scientific principles (Article 2.2). However, the AB finds that the Panel's failure to consider India's presumption that its restrictions were based on international standards and had a scientific basis was in error. The AB thus reverses, in part, the Panel's findings that India's AI measures are inconsistent with Article 2.2. The AB upholds the Panel's findings that India failed to comply with its risk assessment obligations under Articles 5.1 and 5.2.

Finding 2: The AB found that the Panel did not, as India contended, act inconsistently with Article 13.2 of the Dispute Settlement Understanding (DSU) in consulting with the OIE regarding the meaning of the OIE Terrestrial Code. The AB upholds the Panel's findings that India's AI measures are neither "based on," nor "conform to" the relevant international standard (Articles 3.1 and 3.2).

Finding 3: The AB endorses the Panel's finding that India's AI measures violate Article 6 because they require the prohibition of all imports from any country that has notified AI to the OIE, and thus foreclose the possibility

of allowing imports from AI-free areas within such countries. For these reasons, the Appellate Body upheld the Panel's findings that India's AI measures are inconsistent with its obligation to adapt its measures to regional conditions (Articles 6.1 and 6.2).

Finding 4: The AB found that the Panel did not err in finding that the United States had identified alternative measures that would achieve India's appropriate level of protection, and that the Panel did not fail to identify the alternative measures with precision. The AB upholds the Panel's findings that India's AI measures were inconsistent with Article 5.6 because they are significantly more trade-restrictive than required to achieve India's appropriate level of protection.

Finding 5: The AB upholds the Panel's finding that India's AI measures are inconsistent with Article 2.3's prohibition against arbitrary or unjustifiable discrimination.

Case Highlights

- A country's product, health, and safety standards should not be used as disguised trade barriers.
- National regulatory agencies need to balance potential health, safety, and environmental concerns with the nation's obligations under the WTO Agreements.
- WTO's SPS Agreement requires that health, environmental, and safety standards are based on scientific evidence, that they are made transparent to foreign importers, and that they not be any broader than necessary.

development of these standards in other international bodies. The standards are developed by leading scientists in the field and government experts on health protection and are subject to international scrutiny and review.

International standards are often higher than the national requirements of many countries, including developed countries, but the SPS Agreement explicitly permits governments to choose not to use the international standards. However, if the national requirement results in a greater restriction of trade, a country may be asked to provide scientific justification, demonstrating that the relevant international standard would not result in the level of health protection the country considered appropriate.

Adjusting Standards to Conditions

Due to differences in climate, existing pests or diseases, or food safety conditions, it is not always appropriate to impose the same SPS requirements on food, animal, or plant products coming from different countries. Therefore, SPS measures sometimes vary, depending on the country of origin of the food, animal, or plant product concerned. This is taken into account in the SPS Agreement. Governments should also recognize disease-free areas, which may not correspond to political boundaries, and appropriately adapt their requirements to products from these areas. The Agreement, however, checks unjustified discrimination in the use of SPS measures, whether in favor of domestic producers or among foreign suppliers.

Alternative Measures

If an acceptable level of risk can be achieved in alternative ways (such as treatment, quarantine, or increased inspection) that are not as trade restrictive, then the importing country should adopt the less restrictive standards to meet their health objective. Furthermore, if another country can show that the measures it applies provide the same level of health protection, these should be accepted as equivalent. This helps ensure that protection is maintained while providing the greatest quantity and variety of safe foodstuffs for consumers, the best availability of safe inputs for producers, and healthy economic competition.

Risk Assessment

The SPS Agreement requires that SPS measures, and the reasons for them, be made transparent to importers. Countries must establish SPS measures on the basis of an appropriate assessment of the actual risks involved, and, if requested, make known what factors they took into consideration, the assessment procedures they used, and the level of risk they determined to be acceptable. Although many governments already use risk assessment in their management of food safety and animal and plant health, the SPS Agreement encourages the wider use of systematic risk assessment among all WTO member governments and for all relevant products.

Transparency

Governments are required to notify other countries of any new or changed SPS requirements which affect trade, and to set up offices (Enquiry Points) to respond to requests for more information on new or existing measures. They also must open to scrutiny how they apply their food safety and animal and plant health regulations. The systematic communication of information and exchange of experiences among the WTO's member governments provides a better basis for national standards. Such increased transparency also protects the interests of consumers, as well as of trading partners, from hidden protectionism through unnecessary technical requirements.

A special Committee has been established within the WTO as a forum for the exchange of information among member governments on all aspects related to the implementation of the SPS Agreement. The SPS Committee reviews compliance with the agreement, discusses matters with potential trade impacts, and maintains close cooperation with the appropriate technical organizations. In a trade dispute regarding a SPS measure, the normal **WTO dispute settlement** procedures are used, and advice from appropriate scientific experts can be sought.

Genetically Modified Food Case

The U.S. has a very positive attitude toward safety and benefits of genetically modified foods (genetically modified organisms or GMOs). In its trade case against the EU it stated that "consumers in the European Communities have been enjoying the benefits of GMOs, without any adverse health and environmental effects" and that modern biotechnology carries on developing ever more precise and effective methods and that the scientific findings on the safety of the biotech products are confirmed by empirical evidence.

The EU's position is that it has not adopted any general position either in favor or against GMOs. The EU asserts it recognizes the potential benefits that GMO products bring, but the long-term health consequences are unknown. The EU (EC) as a whole and EU countries at the national level have implemented special measures based on the *precautionary principle* (see discussion of the principle below) before approving import and marketing of GMOs within the EU. The U.S. instigated a long-running battle against these measures in a number of WTO proceedings. The *United States v. European Community* case below is a composite of three WTO dispute settlement proceedings brought by the U.S. against the EC (EU).

Precautionary Principle

The basic message of the *precautionary principle* is that on some occasions, measures against a possible hazard should be taken even if the available evidence is not enough to conclude the existence of the hazard as a scientific fact. The lack of full scientific evidence is a prerequisite for applying the principle; if scientific evidence is certain, then the measure would be of prevention rather than precaution. The precautionary principle states that when

United States v. European Community

Genetically Modified Organisms in Foods Case (DS 291, 292 and 293)

The European Community (EC) placed a five-year moratorium on the importation of foods with genetically modified organisms (GMOs). More specifically, the prohibition related to crops engineered through biotechnology or genetically modified crops. In May 2003, the U.S., Argentina, and Canada filed a formal complaint with the WTO. The claim argued that the moratorium was an illegal obstacle to trade under the WTO Agreements. The U.S. requested consultations with the EC concerning certain measures taken by the EC and its member States affecting imports of agricultural and food imports from the U.S. Besides the European-wide moratorium, at the member State-level, the U.S. asserted that a number of EC member States maintain national marketing and import bans on biotech products even though those products have already been approved by the EC for import and marketing in the EC.⁴

According to the United States, the measures are inconsistent with the EC's obligations under WTO's SPS (Sanitary and Phytosanitary) Measures Agreement; Articles I, III, X and XI of the GATT 1994; Agriculture Agreement; and the TBT (Technical Barriers to Trade) Agreement. Australia, Argentina, Brazil, Canada, Chile, Columbia, India, Mexico, New Zealand and Peru joined with the U.S. in the consultations.

Panel and Appellate Body Proceedings

The panel found that the EC applied a general *de facto* moratorium on the approval of biotech products and found that the moratorium violated the SPS Agreement because the *de facto* moratorium led to undue delays in the completion of EC approval procedures.

General Moratorium Was Not Based on a Risk Assessment

SPS Arts. 5.1 (*risk assessment*) and 2.2 (*sufficient scientific evidence*): The EC moratorium was a procedural decision and not a substantive one and, therefore, there was no required risk assessment performed or finding of

sufficient scientific evidence. The Panel found that the general moratorium led to undue delay in the completion of the EC approval procedure.

Safeguards placed on Specific Products Not Based on Sufficient Scientific Evidence

The Panel found that in 24 of the 27 product-specific approval procedures it examined, the procedure had not been completed without undue delay. With regard to the EC member State safeguard measures, the panel found that they were not based on risk assessments satisfying the definition of the SPS Agreement and are presumed to be without sufficient scientific evidence.

The DSB adopted the panel reports.

Implementation of Adopted Reports

On 21 June 2007, the United States and the EC notified the DSB that they had agreed that the reasonable period of time for the European Communities to implement the recommendations and rulings of the DSB would be twelve months.

Case Highlights

- If substantial differences exist over health or safety standards between countries, the WTO Dispute Settlement System (see below) may take a half dozen years to conclude with an acceptable resolution. Two reasons for such a drawn-out process are demonstrated in the GMO cases. First, the complexity of the health issues and the supporting or non-supporting scientific evidence. Second, losing countries may not fully comply with the WTO ruling, which leads to further negotiations and proceedings to obtain approval from the WTO to implement retaliatory sanctions against the non-complying party.
- In order to justify the EU's general moratorium against the importation of GMO products, the SPS Agreement mandates that two requirements must

be met: unbiased risk assessment and a finding of sufficient scientific evidence to support the imposition of the standard. The WTO found that the EU did not perform the required risk assessment to determine if scientific evidence existed to support its health standard.

- The WTO also ruled that the health standards directed at specific products were not supported by sufficient scientific evidence.
- The WTO SPS Agreement does not adopt the precautionary principle found in environmental law (see below).

scientific evidence can neither prove nor disprove that an activity or substance is environmentally damaging, the activity should not progress and conclusively the substance should not be released into the environment. If used correctly, the principle assigns the burden of proof to the potentially polluting industries or countries.

SPS and Agreement on Technical Barriers to Trade (TBT)

The SPS and TBT Agreements both target illicit national standards and policies that unduly restrict international trade. The SPS Agreement focuses on health and safety standards applied to the importation of foodstuffs, while the TBT Agreement is much broader in scope in that it prohibits technical standards relating to any type of product that acts as a disguised trade barrier. The TBT Agreement requires countries to use international standards wherever possible and provide notification of all relevant changes to the “enquiry point” established in their countries. The TBT Agreement covers all technical regulations, voluntary standards, and the procedures to ensure that these are met, except when these are sanitary or phytosanitary measures as defined by the SPS Agreement.

TBT measures could cover any subject, from car safety to energy-saving devices, to the shape of food cartons. To give some examples pertaining to human health, TBT measures could include pharmaceutical restrictions or the labeling of cigarettes. Most food labeling requirements, nutrition claims and concerns, quality and packaging regulations are covered by the TBT Agreement and not by the SPS Agreement. However, by definition, regulations, which address microbiological contamination of food, or set allowable levels of pesticide or veterinary drug residues, or identify permitted food additives, fall under the SPS Agreement. Some packaging and labeling requirements, if directly related to the safety of the food, are also subject to the SPS Agreement.

The two agreements have common elements, including basic obligations for nondiscrimination and similar requirements for the advance notification of proposed measures and the creation of information offices (Enquiry Points). However, many of the substantive rules are different. For example, both agreements encourage the use of international standards, but, under the SPS Agreement, standards for food safety must be justified by scientific evidence of the potential health risks. Under the TBT Agreement, countries may decide that international standards are not appropriate for other reasons, including fundamental technological problems. Governments may introduce TBT regulations when necessary to meet objectives, such as national security or the prevention of deceptive practices. Because the SPS and TBT Agreements have different objectives and rules, it is important for the importer or exporter to know whether their products are subject to the SPS Agreement, TBT Agreement, or both for different reasons.

Other WTO Agreements

Other agreements are also directly related to national import requirements. The **Customs Valuation Code** attempts to standardize country challenges to the valuations placed on goods being imported. It places the burden of proof on the importer to provide additional evidence of valuation. However, a country must give the importer adequate opportunity to respond to the country’s challenge. An associated accord, **Agreement on Preshipment Inspection**, pertains to an importing country’s right to preshipment inspection. This right to pre-inspect goods for quality, quantity, and value is afforded only to developing countries. Because of the limited resources of developing

countries, GATT recognizes their right to hire private companies to inspect the goods in the country of export. The **Agreement on Import Licensing Procedures** is based upon the principle that application procedures should be made as simple as possible. Finally, the work on developing uniform **Country of Origin Rules** is ongoing and should be monitored in the future.

Quantitative Restrictions: Quotas and Embargoes

A quantitative trade restriction relates to the limitation or prevention of certain amounts of a good from being imported into a country. The importing country may want to reduce the amount of a good that can be imported in order to protect domestic businesses (quota), to prevent goods from entering the country due to health and safety concerns (moratorium), and a complete prohibition from the importation of all goods from a certain country for political reasons (embargo). The GMO food case discussed above involved a quantitative restriction involving a European moratorium on the importation of genetically modified food. Quantitative restrictions are typically enforced through quotas, import or export licenses, or other measures such as voluntary export restraints.

The GATT requires the general elimination of these restrictions—except in defined circumstances. Members' notifications on quantitative restrictions are compiled in a WTO database, which is accessible to the public. Article XI of GATT is entitled “General Elimination of Quantitative Restrictions” and makes quantitative restrictions illegal unless they come within a few defined exceptions. Article XI provides the following exceptions to the prohibition of quantitative restrictions:

- (1) temporary export prohibitions or restrictions to prevent or relieve *critical shortages of foodstuffs* or other products essential to the exporting party
- (2) import and export prohibitions or restrictions necessary to the application of *standards or regulations* for the classification, grading, or marketing of commodities
- (3) import restrictions on any *agricultural or fisheries products* necessary to the enforcement of governmental measures.

Article XI also allows WTO members to use quantitative restrictions for pursuing “legitimate policy objectives.” What policy objectives would make a country take the drastic step of imposing a quota, moratorium, or embargo? Governments use import restrictions to protect public health or safety, which was the alleged reason for the EU's moratorium on GMO products. A government sometimes bans all imports of a particular good when it has reason to believe it could harm public safety or health. In 2001, the U.S. prohibited all imports of European livestock because of the “foot and mouth disease” that infected large numbers of livestock in Europe.

The other major purpose of quantitative restrictions is to serve political objectives. The restrictions have been used as punitive sanctions against countries accused of human rights violations, acts of aggression, and for national security reasons. The U.S. currently continues to apply restrictive trade sanctions on a number of countries including Cuba (since 1963), North Korea (1950), Iran (1984), Sudan (2006), Ivory Coast (2006), Syria (2006), Democratic Republic of Congo (2006), and Myanmar or Burma (2007) as well as targeted sanctions against Zimbabwe (anti-democracy actions) and Belarus (anti-democracy). In 2012, the U.S. loosened some of the sanctions against Myanmar to encourage it to transition toward democracy. The next section examines the long-standing U.S. embargo of Cuba.

Cuban Embargo and the WTO's National Security Exception

Embargoes of all trade to a foreign country are rare and often short-lived. Exceptions have been U.S. embargoes against Cuba, Iran, and North Korea. By far, the most controversial one is the U.S.'s longstanding embargo of Cuba, which has lasted over 50 years. The U.S. and Cuba have not had diplomatic relations for five decades because of the communist revolution that gained power in 1959. The *Helms-Burton Act* (Cuban Liberty and

Democratic Solidarity Act) extended the American embargo to include not only U.S. firms but also overseas firms owned or controlled by “U.S. persons.” Helms-Burton also subjected foreign companies doing business with Cuba to litigation in the U.S. The American plaintiffs in such cases would need to prove that the foreign transaction involved property that the plaintiff previously owned in Cuba. Finally, it required exclusion from travel to the U.S. of officers, controlling shareholders (and their families), and of companies that “traffic” in property formerly claimed to be owned by American nationals. The Act resulted in serious foreign relations problems. European, Canadian, and Mexican officials charged the U.S. with unlawfully exercising its jurisdiction extraterritorially, in that it was threatening to punish lawful activity—trade, investment, and tourism carried out by residents of their countries.⁵

The EU challenged the Helms-Burton Act in 1996 by filing a claim with the WTO. However, the EU withdrew, fearing the U.S. would use the national security defense or “get-out” clause found in the WTO Agreements. The “national security exceptions” are found in GATT Article XXI (trade in goods) and in GATS Article XIV (trade in services). The national security exception reads: “Nothing in this Agreement shall be construed . . . to prevent any contracting party from taking any action which it considers necessary for the protection of its essential security interests.” The exception provides a defense for measures that would otherwise be inconsistent with WTO obligations. This exception, however, if given a broad interpretation, could undermine the whole WTO treaty and impair the security and stability of the world trading system.

The rationale behind the exception is that national security is important to all nations, and for an international organization to disregard the importance of this subject and to override national concerns and policies would lead powerful trading nations to ignore or disregard WTO rules. The crucial question is whether a country is the sole decider when its measures are protected by the exception. The answer to this question has been largely avoided since only a few indecisive WTO cases relate to the meaning of the exception.

President Obama created a firestorm with his announcement on December 17, 2014 that the U.S. would establish normal diplomatic relations with Cuba. Diplomatic recognition of another country and its government is an acknowledgement of its *de facto* existence as a nation state. President Obama noted that he was under “no illusion about the barriers to freedom that remain for ordinary Cubans.” The simple step of opening diplomatic relations weakens the national security defense that supports the embargo. Most experts believe that this will be a moot point because most expect a gradual lifting of the embargo to follow.

WTO Dispute Settlement System

The major weakness of GATT was there was no formal body or process authorized to enforce its trade rules. That changed with the *Dispute Settlement Understanding (DSU)*, which came into force with the establishment of the WTO in 1995.⁶ Under the DSU, member countries of the WTO agreed that claims for violating trade rules would no longer be subject to unilateral national actions. Instead, disputes would be settled under the *DSU*. Member countries, but not a private company or industry, may file complaints charging another country or countries of violating WTO rules. The DSU established the **Dispute Settlement System (DSS)**.

A crucial question is how can a country be “forced” into such a process? The philosophical answer is for a country to boycott DSS proceedings, it would jeopardize all members’ long-term interests in building a viable world trade system. The more realistic reason is that of coercion. An abstaining country could be faced with WTO-sanctioned retaliatory measures and threatened with expulsion from the WTO.

The DSS provides for the prompt handling of international trade disputes. Its procedures for settling disputes provide fixed time periods for prompt resolution. In cases that use the maximum time periods and that are appealed, the dispute resolution process should not take more than 15 months. But, as seen in the “Genetically Modified Organisms Case” and as will be seen in the “Bananas Dispute Case” below, cases may continue for years until a final settlement is reached.

The DSU established the **Dispute Settlement Body (DSB)** as the sole authority for appointing the panel of experts to decide cases. Before taking any formal action, the disputing countries must consult with each other in an

attempt to settle the dispute. They can also ask the WTO director-general to mediate the dispute. Upon the failure of consultation, the complaining country can request that a panel be established to hear the dispute. **WTO panels** are like tribunals, usually consisting of three, sometimes five, experts. The activities of the panel are confidential. Before the hearing, each side prepares its case in writing. At the first hearing, both parties present, along with any other country that voices an interest in the case. At a second hearing, both parties submit written rebuttals and present oral arguments. The panel may also consult experts or appoint an advisory group of experts to prepare a report.

The panel prepares a first draft report and submits it to both parties for comments. It then submits an interim report consisting of its findings and conclusions, allowing either party one week in order to request a review. If a review is requested, the panel has two weeks to hold additional meetings with the parties. The panel then submits a *final report*, which becomes the ruling of the DSB (unless the final report is rejected by a unanimous vote of the DSB). The losing party then must prepare and submit a proposal to implement the ruling within a reasonable period of time. In cases where the losing party fails to implement the ruling within a reasonable period of time, the parties must negotiate compensation pending a full implementation. If the parties do not agree on compensation, then the DSB will authorize measures of retaliation for the winning country. These sanctions usually entail withholding or suspending tariff concessions previously mandated under GATT.

Dispute Settlement Acronyms

Dispute Settlement Understanding: DSU

Dispute Settlement System: DSS

Dispute Settlement Body: DSB

Appellate Body: AB

The DSU established the DSS, which includes a three-tier system: Dispute Resolution Panels > AB > DSB (issues measures of retaliation in cases of noncompliance).

The diagram of the dispute resolution procedure created by the DSU is shown in Figure 5.4. The process begins at the bottom of the diagram with consultations between the disputing parties. At the top of the chart is the case where, despite a ruling by the Appellate Body, the losing country fails to comply, which leads to the final step where the DSB authorizes retaliatory sanctions against the noncomplying party.

The DSS of the WTO is a cornerstone of the international trading system. The DSS was strengthened and streamlined as a result of reforms agreed to following the Ministerial Meeting held in Montreal in December 1988. A major rule change no longer requires the consent of the parties to the dispute for the establishment and composition of WTO panels.

The DSU emphasizes the importance of consultations in order for the parties to reach a voluntary settlement and requires the disputants to enter into consultations within 30 days of a request for consultations from one of the members. If after 60 days from the request for consultations there is no settlement, the complaining party may request the establishment of a panel. By mutual agreement, the parties may follow alternative means of dispute settlement, including conciliation, mediation, and arbitration. When a request for consultations is rejected, the complaining party may move directly to request a panel.

WTO panels normally consist of three persons of appropriate background and experience from countries not party to the dispute. The Secretariat maintains a list of experts satisfying the criteria for particular types of disputes. The DSU envisages that a panel will normally complete its work within six months or, in cases of urgency, within three months. Panel reports may be considered by the DSB for adoption 20 days after they are issued to the parties to the dispute. Within 60 days of their issuance, they will be adopted, unless the DSB decides by consensus not to adopt the report, or one of the parties notifies the DSB of its intention to appeal.

TRADE REGULATION

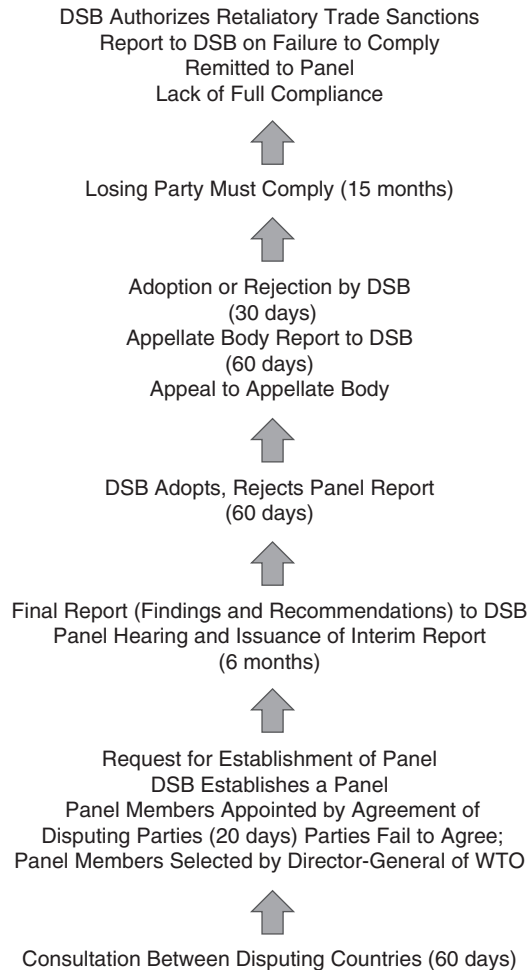


Figure 5.4 WTO Dispute Settlement System.

The concept of appellate review is an important feature of the DSU. An Appellate Body is composed of seven members, three of whom will serve on any one case. An appeal will be limited to issues of WTO law covered in the panel report and legal interpretations developed by the panel. Once the panel report or the Appellate Body report is adopted by the DSB, the party concerned will have to notify its intentions with respect to implementation of adopted recommendations. Further provisions set out rules for compensation or the **suspension** of concessions in the event of non-implementation. Disagreements over the proposed level of suspension may be referred to arbitration.⁷

The next section provides an illustration of the WTO DSS at work in the famous U.S.–EU Bananas Dispute.

United States–EU “Bananas Dispute”

On January 14, 1999, the United States requested the DSB as required by the DSU of the WTO to authorize the suspension of existing tariff concessions to the EU in the amount of \$520 million. This was requested pursuant to a decision of a WTO Dispute Resolution Panel that the EU had illegally placed restrictions on the importation of

bananas into EU countries. The EU objected to the amount of the *suspension* as not being equivalent to the level of *nullification* or *impairment* of benefits suffered by the United States.

The level of suspension was submitted for arbitration. Pursuant to the DSU, the level of suspension is to be determined by the following principles: (1) the complaining party should first seek suspension of benefits in the *same sector* as that in which the impairment or nullification was found; (2) if this is not practical, then it should seek suspension or concessions “in other sectors under the same agreement”; and (3) if that is not practical, then it should seek a suspension under another covered agreement.⁸ The basic rationale of these principles is to ensure that suspensions or concessions across different sectors remain the exception and not the rule. It would seem that sector-specific concessions or suspensions are preferred in order to prevent an escalation of animosities and a broader trade war.

The panel decision held that the EU import regime pertaining to bananas violated both the goods sector (GATT) and the services sector (GATS). It should be noted that the U.S. requested the suspension only after it had won the dispute before the WTO panel and the EU had failed to abide by the panel’s decision. The revised import regime instituted by the EU in response to the decision continued to place tariff quotas on bananas imported from the Caribbean and South America. This violated the national treatment principle of GATT and GATS in which like products are to be treated equally, irrespective of their origin. In order to be in violation of the nondiscrimination principle, two elements must be proved. First, the services or goods at issue must be sufficiently alike. Second, the imported goods or services are treated less favorably than those of domestic origin. The arbitration panel held that the revised bananas import regime of the EU continued to violate the national treatment principle. It was a continuation of nullification or impairment of U.S. benefits found under the previous EU regime.

The arbitration panel then turned to the remaining issue of whether the concessions requested by the U.S. were appropriate. In determining the level of concessions, the WTO panel may consider both direct and indirect benefits. Consideration of *indirect benefits* was especially important in this case because the U.S. is not an exporter of bananas. Instead, the U.S. argued that the restrictions on Latin American banana exports indirectly impaired U.S. exports. For example, the U.S. exports farm products, such as fertilizers, used in the production of bananas that would have been exported to the EU. The arbitration panel ultimately decided that the concessions requested were excessive even with the consideration of indirect benefits. It reduced the concession amount from the approximately \$500 million requested by the U.S. to \$191.4 million.

Anti-dumping and Illegal Subsidies

Dumping is considered an actionable trade practice when it disrupts markets and injures producers of competitive products in the importing country. Article VI of GATT permits the imposition of special anti-dumping duties on goods equal to the difference between their export price and their “normal value.” An anti-dumping duty is a special duty imposed to offset the price effect of dumping (importing) goods below their normal value and which is determined to be materially harmful to domestic producers. **Illegal subsidies** are government payments or other financially quantifiable benefits provided to domestic producers or exporters contingent on the export of their goods and services. Countervailing duties are imposed against illegally subsidized imported goods or against the exporting country to offset the amount of government subsidies, which cause material injury to a domestic industry in the country of import. The WTO system of enforcement allows for unilateral retaliation at the national level for violations of the GATT agreements.

Illegal Subsidies

Illegal government subsidies, given to an exporter by its home country, result in the lowering of import pricing, which gives the importer a competitive advantage over domestically produced products. The U.S. **Tariff Act of 1930** provides a broad definition of subsidy by stating that a subsidy occurs when a foreign government authority “provides a financial contribution, any form of income or price support, makes a payment to a funding mechanism to provide a financial contribution, or entrusts or directs a private entity to make a financial contribution.”

Section 337 of Tariff Act of 1930 defines a subsidy as including “financial contributions” and “benefits” conferred and defines them as follows:

A “financial contribution” includes the:

- 1 direct transfer of funds, such as grants, loans, and equity infusion, or the potential direct transfer of funds or liabilities, such as loan guarantees;
- 2 foregoing or not collecting revenue that is otherwise due, such as granting tax credits or deductions from taxable income;
- 3 providing goods or services, other than general infrastructure, or purchasing goods.

A “benefit” shall normally be treated as conferred where there is a benefit to the recipient, including in:

- 1 the case of equity infusion, if the investment decision is inconsistent with the usual investment practice of private investors, including the practice regarding the provision of risk capital, in the country in which the equity infusion is made;
- 2 the case of a loan, if there is a difference between the amount the recipient of the loan pays on the loan and the amount the recipient would pay on a comparable commercial loan that the recipient could obtain on a market;
- 3 the case of a loan guarantee, if there is a difference, after adjusting for any difference in guarantee fees, between the amount the recipient of the guarantee pays on the guaranteed loan and the amount the recipient would pay for a comparable commercial loan if there were no guarantee by the authority; and
- 4 in the case where goods or services are provided, if such goods or services are provided for less than adequate remuneration, and in the case where goods are purchased, if such goods are purchased for more than adequate remuneration.

WTO’s **Code on Subsidies and Countervailing Duties** allows an importing country to impose duties when it can prove that a foreign subsidy would cause injury to a domestic industry. If the U.S. International Trade Commission (USITC) determines that a foreign government has provided a subsidy (financial contributions or benefits), it may impose additional charges against the imported goods. Such duties are popularly referred to as countervailing duties. They are extra duties or charges countries place on imported goods to offset the subsidies granted to the exporters by their home governments. For more information on U.S. trade law, as it relates to the retaliation against illegally subsidized goods and the dumping of goods (discussed in the next section), refer to Chapter 6’s *Doing Business Internationally*: “Summary of U.S. Trade Remedies.” Figure 5.5 *Comparative Law*: “United States Found in Violation of WTO Agreement on Subsidies” discusses a WTO case in which tax credits provided to exporters by the U.S. Foreign Sales Corporation tax regime were held to be illegal export subsidies.

Anti-dumping

The WTO Anti-dumping Agreement and Article VI of GATT authorize importing countries to impose extra tariffs on imports found to be dumped causing material injury or posing a threat to the domestic industry producing a like product. Article VI defines dumping as sales for export below normal value. A product’s “normal value” is the comparable price for sales within the exporting country or to a third country, or the cost of production plus overhead and profit. The most common trade violation is the dumping of goods on foreign markets. Dumping or price discrimination is when a foreign exporter sells goods below what it sells them in its home country or below the cost of production.

United States manufacturers can petition the Department of Commerce (DOC) to place anti-dumping duties on such imports. The DOC is required to conduct an administrative review to determine the amount of the anti-dumping duty that should be assessed. Anti-dumping duties, however, are considered the last resort in protecting domestic industries from unfair foreign competition.

A panel created by the Dispute Settlement Body of the WTO issued its final report concluding that the U.S. Foreign Sales Corporation tax regime creates illegal export subsidies. A Foreign Sales Corporation (FSC) is a corporation given special tax treatment (tax credits for exporting goods) under the U.S. tax laws, and the purpose of the FSC provisions is to promote U.S. exports in a manner compatible with the agreements negotiated between the U.S. and its trading partners. The European Union (EU), which has opposed the FSC regime since its enactment in the mid-1980s, filed a complaint against the United States. Specifically, the EU complaint alleged that the FSC regime violates certain export subsidy prohibitions of the WTO Agreement on Subsidies and Countervailing Measures by granting tax subsidies contingent upon export performance and tax subsidies contingent upon the use of domestic over imported goods.

The U.S. position has consistently been that the FSC regime is not an illegal export subsidy. The FSC represents a partial

adoption of the territorial approach to taxation, common in Europe, and intended to equalize the position of U.S. manufacturers in markets outside the U.S. such as the EU, where the availability of VAT rebates along with territorial taxing schemes make non-U.S. goods cheaper than those manufactured in the U.S. After consultations between the EU and the U.S. failed to resolve their differences, the EU requested that the WTO's Dispute Settlement Body form a panel to rule on the issue. The WTO's panel released its findings in a 298-page report. The panel concluded that the U.S. FSC regime creates illegal export subsidies and should be abolished. In reaching that conclusion, the WTO panel found that the FSC regime "clearly confers a benefit, in as much as both FSC's and their parents need not pay certain taxes that would otherwise be due" and that the subsidies are "contingent upon export performance" because they are available only with respect to "foreign trade income."

Figure 5.5 *Comparative Law*: United States Found in Violation of WTO Agreement on Subsidies.

The anti-dumping duty is assessed on an entry-by-entry basis in an amount equal to the difference between the U.S. price of the good and the foreign market value of the good. Anti-dumping duties can be as high as 400 percent of the value of the goods being imported and can be assessed for periods of up to 20 years. To be successful in its position, a company or industry must provide evidence to the DOC that foreign exporters are dumping their goods on the U.S. market. It must also persuade the USITC that the dumping threatens to cause material injury to U.S. industry.

Injury due to goods being imported at "less than fair value" can be proven showing one of the following: (1) sales lost to imports sold at "less than fair value," (2) suppression of export prices through underselling, (3) lost profits, (4) reduced employment or capacity utilization, (5) declining sales, (6) growth of imports, (7) reduced product development abilities, or (8) magnitude of the dumping margin.⁹ If the DOC finds a case of dumping and the ITC finds material injury, then the DOC issues an *anti-dumping order* fixing the duties to be levied against the foreign exporters. The next section discusses a WTO challenge of the U.S. method of calculating anti-dumping duties through the practice of "zeroing."

Anti-dumping and the Zeroing Case against the United States

In 2004 and 2007, the EU launched WTO disputes against the U.S. for the use of a methodology called **zeroing** in the calculation of anti-dumping duty rates. The EU's initiative was followed by a number of countries including Brazil, China, Ecuador, Japan, Korea, Mexico, Thailand, and Vietnam. The WTO Appellate Body has consistently condemned the practice of zeroing as unfair. Finally, on February 14, 2012, the U.S. DOC announced a policy change to end the practice of zeroing in anti-dumping cases.

WHAT IS ZEROING?

The DOC and other anti-dumping authorities calculate the margin of dumping for a product by computing the difference between normal value and the import price for each model or type of a particular product, and aggregate the results to determine the amount of the anti-dumping duty. Zeroing means that the DOC would omit the cases where the export price was *higher* than normal value. By doing so, it inflated dumping margins and the duties imposed. WTO rulings have confirmed that this method increases, often substantially, the exporter's margin of dumping and thus the amount of anti-dumping duty that the exporter has to pay.

CONSEQUENCES OF ZEROING

The consequences of zeroing are best demonstrated through an example. Suppose three shipments of the same product are imported into the U.S. during a DOC review period. At the time of export: (1) when the first shipment arrived, the product sold at \$1000 in its home country (country of export) with the import price (U.S.) set at \$900; (2) when the second shipment arrived, the home price was \$1000 and the import price was \$1100; and (3) when the third shipment arrived, the home price was \$1000 and the import price was \$1000. The difference between the home price and the import price is recognized as dumping. The first shipment, taken alone, generates a \$100 ($\$1000 - \$900 = \100) anti-dumping duty, but the three shipments taken together would generate no anti-dumping duty ($\$100 + -\$100 + 0 = 0$). Under WTO rules, there would be no duties owed to the U.S. because during the review period (three shipments) the *average* home market price (\$1000) was the same as the average import price (\$1000).

When applying zeroing, the U.S. compares the price of the product in its home market with the price of the product on the U.S. market, but disregards, by setting at zero, all transactions in which the price of the product on the home market is smaller than the price on the U.S. market. Thus, the second shipment is registered as a 0 and not as a -100. The U.S. authorities would then recognize a dumping margin of \$100 ($\$100 + 0 + 0$). It would then apply an anti-dumping duty at a rate of 3.33 percent. The anti-dumping duty rate is the percentage of the dumping margin (\$100) to the total value of the goods imported (\$3000). Other countries deem this to be unfair since it captures foreign exporters that make a strong effort not to dump their products. For example, 19 times out of 20, an exporter exports goods at or above the home market prices and, yet, is made to pay an anti-dumping duty on all 20 shipments (19 zeros for above market pricing + the anti-dumping margin of the one case of underpricing). This is the case in the majority of anti-dumping cases. The only time zeroing is not an issue is when all the shipments are priced under the home market price, which is a classic case of the dumping of goods on a foreign market.

PRACTICE OF ZEROING IN THE U.S. SYSTEM

Unlike almost every other country in the world, the U.S. does not assess and collect duties at the time of importation. Instead, it holds the projected duty on deposit pending a final assessment at a later date. If a foreign exporter to the U.S. is determined to have dumped goods, then the amount collected as a deposit increases for a period of a year (anti-dumping rate assessed) to future imports of the exporter goods. At the end of the following year, the exporter can request a review and ask for a refund if the dumping margin set for that year is below the original deposit amount. If no review is requested, the U.S. keeps the entire cash deposit.

After losing the first WTO zeroing case in 2004, the U.S. abolished the type of zeroing explained in the above example. In such a situation, the import above home market price (\$100) (shipment 2) would “offset” the \$100 dumping margin related to shipment 1. However, the example is at the level of *original investigations* and assessment of duties by the ITC. In *administrative reviews*, however, the U.S. continues to practice zeroing. Administrative reviews occur when requested by an interested party, such as a foreign exporter challenging the assessment of an anti-dumping duty or a domestic company accusing an exporter of dumping. It is at this stage of reviews that about 90 percent of anti-dumping duties are usually determined. There is also a procedure known as **sunset reviews**, which are carried out every five years to establish if an anti-dumping duty is still justified. To the extent the past “dumping margins are affected by zeroing (which they almost always are), zeroing has played a key role” in continuing anti-dumping duties through the sunset review process. In sum, zeroing inflates the amount of duty collected and increases the dumping margin rates. Given the U.S. agreement not to use zeroing in its annual assessment of duties, which are the basis of the five-year sunset reviews rates, it seems that zeroing will disappear in the context of sunset reviews as well. The U.S. has also agreed to abandon zeroing in its administrative reviews. Below is a list (in reverse chronological order) of some of the WTO complaints filed against the practice of zeroing. The list illustrates the protracted nature of major trade disputes when a country fails to fully comply. It is followed by a review of the process leading to a 2012 settlement agreement between the U.S. and Japan. See Figure 5.6 *Doing Business Internationally*: “Japan v. United States (Zeroing).”

Threatened by trade retaliation against U.S. exports by the EU and Japan, on February 14, 2012, the U.S. DOC announced a policy change to end the practice of “zeroing” in anti-dumping cases. The policy change covers future administrative reviews of existing anti-dumping orders. However, the U.S. made it clear that it is not likely to stop trying to negotiate the appropriateness of zeroing.¹⁰

The question in dispute was whether Articles 2.4 and 9.3 of the WTO Anti-dumping Agreement, which governs administrative reviews, should exclude zeroing. Under the U.S. system, the anti-dumping duty rate established by the DOC does not determine an importer’s final anti-dumping duty liability. In the U.S. system, the importer is required to make a cash deposit as security at the time of importation. The importer, or any interested party, such as a domestic producer or a foreign exporter or producer, may ask the DOC to perform an administrative review. In its review, the DOC gathers data on actual export prices and normal values for the period under review, and it calculates the margins of dumping. If the calculated dumping margin is higher than the cash deposit, the importer must pay the difference with interest, and if it is lower, the difference is refunded with interest. If no periodic review is requested, the duty assessment becomes legally final at the initial cash deposit rate.

The U.S. has argued that “dumpers” should not be able to hide targeted dumping by averaging dumped prices in competitive markets with non-dumped prices in non-competitive markets. After the initial WTO rulings against the U.S., U.S. anti-dumping authorities did only the minimum to comply with the ruling on zeroing. After the Appellate Body found that zeroing in investigations violated Article 2.4 of the Anti-dumping Agreement, the DOC eliminated zeroing in original investigations but continued to use zeroing in administrative reviews. The EU and Japan then pursued and won WTO challenges to U.S.’ use of zeroing in administrative reviews, and then pursued compliance proceedings.

They both threatened trade retaliation against U.S. exports unless the DOC stopped using zeroing in administrative reviews.

Meanwhile, the Court of Appeals for the Federal Circuit ruled that the inconsistency in the DOC’s interpretation of U.S. law as permitting both non-use of zeroing in original investigations and use of zeroing in administrative reviews was arbitrary and unreasonable. But still, the DOC failed to eliminate zeroing in all types of reviews.

On February 6, 2012, the U.S., together with the EU and Japan, announced that it had reached agreement settling its zeroing disputes. The agreement provides that the U.S. will expeditiously complete the process of abandoning all use of zeroing in assessing anti-dumping duties to comply with WTO dispute settlement decisions. In the reviewing of an anti-dumping duty order, administrative review, the DOC will calculate weighted-average margins of dumping and anti-dumping duty in a manner which provides offsets for non-dumped shipments while using monthly average-to-average comparisons in reviews instead of annual reviews (WTO-consistent methodology). The DOC agreed also to modify its practice in five-year (sunset) reviews, using the weighted-average dumping margins found to be WTO conforming. The final type of proceeding not connected to the elimination of zeroing is *targeted dumping* cases for which the WTO has yet to hear a case.

Due to the future-looking nature of remedies under the WTO system, the current U.S. policy change does not entail the U.S. paying compensation for past cases of zeroing. The U.S. policy change on zeroing brings the U.S. into conformity with the relevant WTO Appellate Body decisions. Some countries, such as Korea, still want to continue to challenge the U.S. in order to obtain refunds for past cases of zeroing. If DOC uses zeroing in targeted dumping situations, the story will continue with further WTO cases.

Figure 5.6 *Doing Business Internationally: Japan v. United States (Zeroing).*

- Joint Communication from the United States and Japan, *United States’ Measures Relating to Zeroing and Sunset Reviews*, [WT/DS322/44](#) (February 8, 2012)
- *United States’ Measures Relating to Zeroing and Sunset Reviews Recourse to Article 22.6 of the DSU by the United States: Communication from the Arbitrator*, [WT/DS322/38](#) (December 15, 2010)
- *United States’ Laws, Regulations and Methodology for Calculating Dumping Margins (Zeroing) Recourse to Article 22.6 of the DSU by the United States: Communication from the Arbitrator*, [WT/DS294/39](#) (December 8, 2010)
- Appellate Body Report, *United States’ Measures Relating to Zeroing and Sunset Reviews—Recourse to Article 21.5 of the DSU*, [WT/DS322/AB/RW](#) (August 18, 2009)
- Appellate Body Report, *U.S.’ Laws, Regulations and Methodology for Calculating Dumping Margins (Zeroing)—Recourse to Article 21.5 of the DSU*, [WT/DS294/AB/RW](#) (May 2009)
- Appellate Body Report, *United States’ Continued Existence and Application of Zeroing Methodology*, [WT/DS350/AB/R](#) (February 4, 2009)
- Appellate Body Report, *United States’ Final Anti-Dumping Measures on Stainless Steel from Mexico*, [WT/DS344/AB/R](#) (April 30, 2008)
- Panel Report, *United States’ Final Anti-Dumping Measures on Stainless Steel from Mexico*, [WT/DS344/R](#) (December 20, 2007)

- Appellate Body Report, *United States' Measures Relating to Zeroing and Sunset Reviews*, WT/DS322/AB/R (January 23, 2007)
- Appellate Body Report, *United States' Final Dumping Determination on Softwood Lumber from Canada (Article 21.5 Canada)*, WT/DS264/AB/RW (September 1, 2006)
- Appellate Body Report, *United States' Laws, Regulations and Methodology for Calculating Dumping Margins (Zeroing)*, WT/DS294/AB/R (May 9, 2006)
- Appellate Body Report, *United States: Final Dumping Determination on Softwood Lumber from Canada*, WT/DS264/AB/R (August 31, 2004)

WTO Authorized Unilateral Actions

The WTO Agreements allow countries to take unilateral actions in some situations when their national laws on trade are violated. Two U.S. laws that continue to be enforced unilaterally are Section 301 of the **Tariff Act of 1974** and Section 337 of the Tariff Act of 1930.

Section 301 of the Tariff Act of 1974

The Office of the **U.S. Trade Representative (USTR)** is authorized by statute to retaliate against activities of other countries that are deemed to violate U.S. rights under international trade agreements. The USTR coordinates the development of U.S. trade policy, negotiates international trade regulations on behalf of the U.S., and seeks to expand U.S. exports by promoting the removal of foreign trade barriers and the opening of foreign markets. USTR retaliation is popularly referred to as Section 301 sanctions.¹¹

Section 301 provides a means to counter a broad range of unfair foreign trade practices, including discriminatory rules of origin, discriminatory government procurement, licensing systems, quotas, exchange controls, restrictive business practices, discriminatory bilateral agreements, taxes that discriminate against U.S. products, and discriminatory product standards.

Section 301 investigations are initiated by the USTR in response to an interested party's petition. The USTR allows U.S. businesses to approach it on an informal and confidential basis with pertinent information and a justification to begin a USTR investigation. This confidential alternative diminishes the risk that a foreign country will seek retribution against the party for instigating a Section 301 proceeding. Whether by formal or informal means, the interested party seeking to invoke Section 301 must provide detailed information on both the foreign trade practice complained of and its impact on U.S. commerce.

The deadline for completing Section 301 investigations involving rights under a trade agreement is 18 months, while investigations of alleged unreasonable, discriminatory, or unjustified practices must be completed within 12 months. An expedited investigation not exceeding six months is undertaken when there are allegations that a foreign country has failed to provide adequate and effective intellectual property rights protection. If the allegations are found to be true, the USTR may retaliate by suspending trade agreement concessions, imposing duties or other import restrictions, imposing fees or restrictions on services, restricting service sector authorizations, or by procuring compensatory benefits for the U.S.

Before such sanctions can be administered, the Tariff Act requires that the DOC determine that a government is providing, directly or indirectly, a **countervailing subsidy** with respect to the manufacture, production, or export of merchandise. If the USTR determines that such an illegal subsidy has been given, then it will pursue bilateral negotiations with the offending country and, if necessary, will institute a formal dispute resolution proceeding. If the dispute remains unresolved, the USTR is authorized to impose *unilateral* trade restrictions equal to the amount of harm to U.S. commerce. The *Delverde USA v. United States* case explores the meaning of an illegal foreign subsidy and the assessment of a countervailing duty.

The EU challenged the unilateral nature of Section 301 as a violation of the WTO Agreements. It alleged that the speed of retaliation under Section 301 violated the WTO DSU. The WTO DSB upheld a WTO panel's report that the rights exercised by the U.S. under Section 301 did not violate the DSU. The practice of the USTR to consult with

the foreign government in order to resolve the dispute before authorizing sanctions satisfied the requirements of the WTO. For a review of the use of Section 301, see Figure 5.7 *Doing Business Internationally*: “Applying Section 301.”

Delverde USA, Inc. v. United States

202 F.3d 1360 (Fed. Cir. 2000)

Lourie, Circuit Judge. Delverde, SrL (“Delverde”) and Delverde USA, Inc., appeal from the September 25, 1998, decision of the U.S. Court of International Trade affirming the Department of Commerce’s (DOC) countervailing duty determination under Section 771(5) of the Tariff Act of 1930 (Tariff Act). The DOC launched a countervailing duty investigation and discovered that, in 1991, Delverde purchased certain corporate assets, namely, a pasta factory and related production assets from a private company that had previously received countervailable subsidies from the Italian government.

DOC determined that the purchasing company should be allocated a portion of the illegal subsidy and made to pay countervailing duties. After determining the amount of the subsidy it divides that amount by the number of years equal to “the average useful life of renewable physical assets in the industry concerned.” DOC determined that the average useful life to be 12 years and allocates an amount to each year accordingly. A *pro rata* portion of that subsidy then “passes through” to the purchaser at the time of the sale.

We conclude that the statute does not contemplate any exception to the requirement that DOC determine that a government provided both a financial contribution and benefit to a person, before charging it with receipt of a subsidy, even when that person bought corporate assets from another person who was previously subsidized. In other words, the Change of Ownership provision does not change the meaning of “subsidy.” A subsidy can only be determined by finding that a person received a “financial contribution” and a “benefit.”

Having determined that the meaning of the statute is clear, we need only determine whether DOC’s methodology is in accordance with the statute. We have concluded

that it is not. Nowhere following its methodology did DOC determine whether Delverde directly or indirectly received a financial contribution and benefit. Rather, the DOC’s methodology conclusively presumed that Delverde received a subsidy from the Italian government simply because it bought assets from another person who earlier received subsidies.

Lastly, an “effect” of a subsidy is a competitive advantage that the subsidy recipient obtained from the subsidies. It is undisputed that Delverde was not the direct recipient of any subsidy. The question is whether Delverde was an indirect recipient by having purchased assets from a company that did directly receive one. As we stated earlier, the statute does not permit DOC simply to assume that Delverde received a *pro rata* portion of those subsidies. The decision of the Court of International Trade is VACATED and REMANDED.

Case Highlights

- An illegal subsidy given by a foreign government can be attributed to the purchaser of the company that had received the subsidy. A *pro rata* portion of those subsidies can be assessed based upon the remaining useful life of the equipment and assets when purchased by the second company.
- The DOC cannot assume that when a company sells “productive assets” during “the average useful life,” a *pro rata* portion of the subsidy used to purchase those assets “passes through” to the purchaser at the time of the sale.
- The DOC must show that an illegal subsidy was given and that the purchaser of the company at least indirectly benefited from the earlier subsidy before assessing a countervailing duty.

Section 337 of the Tariff Act of 1930

Section 337 of the Tariff Act of 1930 provides for relief to be given by the ITC for “unfair methods of competition” in the importation or sale of imported goods. Proof of infringement of intellectual property rights relating to the imported goods is usually sufficient to prove injury. Section 337 does not define “unfair competition,” but patent, copyright, and trademark infringement are all considered unfair competition. Section 337 is most commonly used to prevent the import of illegal pirated or counterfeited goods (see Chapters 18 and 19). Standing to seek relief from the ITC requires the showing infringement of an intellectual property right in the U.S.

Actionable practices under Section 301 are acts or policies engaged in by U.S. trading partners that violate a trade agreement, or are found to be unjustifiable, unreasonable, or discriminatory, and burden or restrict U.S. commerce:

- 1 *Trade Agreement Violations*: Where a country violates the terms of a bilateral or multilateral agreement with the United States, Section 301 can be invoked to impose sanctions against imports of that country.
- 2 *Unjustifiable, Unreasonable, and Discriminatory Practices*: An act, policy, or practice is regarded as “unjustifiable” if it denies most-favored-nation treatment to U.S. exports or national treatment to U.S. business interests, if it fails to protect U.S. intellectual property rights, or if it denies U.S. businesses the right of establishment in a foreign country. The term “unreasonable” refers to acts, policies, or practices that are “unfair and inequitable,” even though they may fall short of violating the international legal rights of the U.S. If any country treats U.S. products, services, or investments less favorably than those supplied by domestic or third-country sources, that country is the subject of a “discriminatory practices” determination. Before retaliatory action can be taken, the USTR must determine that the practice burdens or restricts U.S. commerce.
- 3 *Burdens or Restricts U.S. Commerce*: The term “U.S. commerce” refers to the transnational flow of U.S. goods, as well as trade-related services and investments. A foreign practice “burdens or restricts” U.S. commerce if it causes

immediate harm to U.S. interests in some significant and measurable way, or forecloses future market opportunities that would otherwise be available.

Retaliation and Settlement under Section 301 provides that, before any trade sanctions may be imposed, the USTR must consult with the government of the country charged with an offending practice with a view toward a negotiated settlement of the dispute. The threat that U.S. market access could be reduced or eliminated, under Section 301, is instrumental in achieving settlements. Section 301 has gained increased importance as a means of enforcing the results of binding dispute settlements from the WTO: Countries that fail to implement the recommendations of WTO panels can face Section 301 trade retaliation. The types of unfair trade practices found actionable include:

Discriminatory Government Procurement Practices: USTR initiated several investigations concerning discrimination by the Japanese government involving outright prohibitions on the procurement of foreign satellites or certain Japanese exclusionary practices such as technical standards favoring Japanese producers.

Quotas, Tariffs, and Licensing Schemes: Section 301 was invoked in the “bananas case” discussed earlier in this chapter. The retaliatory tariffs were imposed as a result of the EU’s failure to modify its banana quotas and import licensing schemes. The dispute originated with a Section 301 petition filed by Chiquita Brands International, Inc., alleging discriminatory treatment against U.S. commercial interests in certain banana-producing countries.

Figure 5.7 *Doing Business Internationally*: Applying Section 301.

The sole remedy under Section 337 is the exclusion of the goods from the U.S. No damages can be granted. A permanent exclusion order prohibits entry of any of the specified goods produced by the named foreign producer or importer into the U.S. A party may also obtain a **cease and desist order** prohibiting future imports by the accused importer or distributor. The minimum daily penalty for violating an exclusion or a cease and desist order is \$100,000 or twice the domestic value of the imported goods. An investigation may be opened upon petition from a domestic producer. Any decision of the ITC may be appealed to the Court of Appeals for the Federal Circuit.

Criticism of the WTO: Protecting the Environment

For most WTO members, environmental issues have been at best ancillary to core international trade issues and disputes.¹² Critics have cited a number of WTO rulings that appear to place free trade issues above environmental concerns. One decision held that portions of U.S. environmental law were inconsistent with GATT’s Article XX, which exempts certain kinds of domestic legislation from GATT’s overall ban on discriminatory trade restrictions. The sacrifice of U.S. environmental standards to free trade has been a rallying cry for many environmentalists and labor activists who opposed both NAFTA and the WTO. The WTO’s “Shrimp-Turtle” decision in particular seemed to validate the protesters’ fears by its finding that Section 609 of the Endangered Species Act (requiring the United States to ban the importation of shrimp from nations that did not require their commercial fishing vessels to employ specified turtle excluder devices) was inconsistent with Article XX because it unjustifiably restricted international trade. A WTO panel also found the Environmental Protection Agency’s “Reformulated Gasoline Rule” (Clean Air Act) was invalid. WTO rules exclude nongovernmental organizations (NGOs) from participating in trade disputes over the legitimacy of environmental measures adopted by member states.

Reforming the WTO

Unlike the World Bank, the WTO has no affirmative charge to alleviate poverty or stimulate development; its task is essentially negative—to remove barriers to international trade in goods and services. It was after pressure from environmental groups and other NGOs, and most importantly a bloc-developing country, that world criticism of the dangers of unrestrained global trade got the attention of the WTO.

Suggestions for reforming the WTO include adopting formal rules for the participation of NGOs as *amici* (friend of) in its environmental disputes. The WTO should also move rapidly to establish and fund its technical assistance center for developing countries in order to permit more effective participation in formal dispute settlement proceedings and underlying trade debates policy. The developing countries made their voices heard in delaying the Doha Round and have successfully negotiated more favorable terms.

The environmental impact assessments required by the World Bank, particularly for its national development programs, could provide a model for periodic assessments of the environmental impacts of global trade on individual countries, regions, or industries. WTO environmental assessments would help inform future WTO negotiations and dispute settlement proceedings. Few industries like being classified as environmentally irresponsible. For a discussion of environmental ethics in the context of a free trade agreement (NAFTA), see Chapter 6's discussion of the *maquiladora* industry along the Mexican–U.S. border.

Chapter Summary

- 1 The free trade era begin with the establishment of GATT in 1948 with the goal of reducing worldwide tariff rates. The establishment of the WTO and the Dispute Settlement Body in 1994–1995 the free trade agenda expanded to reducing nontariff barriers to trade. The package of agreements known as the 1994 WTO Agreements covers most areas of nontariff trade barriers.
- 2 The three foundational principles of GATT-WTO are: (1) most-favored-nation principle, (2) national treatment principle, and (3) transparency principle. The most-favored-nation principle requires WTO members to offer its lowest tariff rates to members of the WTO. The application of this principle is the method by which tariffs rates have been lowered. The national treatment principle applies once goods have been imported into a country. Once foreign goods pass through customs, they are to be treated the same as goods produced in the country of import. The principle of transparency requires countries to provide clear and accessible customs regulations so that they are not used as disguised barriers to trade.
- 3 The 1994 WTO Agreements established the WTO and was packaged with a list of side agreements dealing with most aspects of international trade including infringement of intellectual property rights, trade in services, foreign direct investment, and government procurement. In order to be a member of the WTO a country must not only accept the central WTO agreement but also must accept all of the side agreements.
- 4 Quantitative barriers to trade include quotas, moratoriums, and embargoes.
- 5 Two of the major violations of WTO rules are the dumping (selling price below normal value) of goods on foreign markets and illegal government subsidies of national producers and exporters.
- 6 Countries have the right to establish their own health, safety, environmental, and technical barriers. However, the Agreement on the Application of Sanitary and Phytosanitary Measures (SPS) and the Agreement on Technical Barriers to Trade (TBT) provide rules to prevent standards from being used as disguised trade barriers.
- 7 The WTO Dispute Settlement System provides an orderly process for resolving trade disputes. The system requires the disputing countries to consult in the hope of reaching a negotiated settlement. If a settlement is not voluntarily reached, then an expert panel reviews the arguments and evidence and issues a report, which is then reviewed by the Dispute Resolution Body for approval. A party may appeal the ruling to the Appellate Body. The losing party can often delay implementation of the ruling, but will eventually comply to avoid or minimize retaliatory sanctions. The process, although drawn out at times, has prevented trade wars between disputing countries.

- 8 Countries may take unilateral actions under WTO rules for unfair trade practices. Such unilateral measures are authorized under Sections 301 (retaliation for breaches of trade agreements and unjustifiable, unreasonable, or discriminatory acts against American businesses) and 337 (infringement on American intellectual property rights) of the U.S. Tariff Acts.
- 9 The WTO trading system has been criticized for ignoring environmental, human rights, and antipoverty concerns.

Key Terms

Agreement on Import Licensing Procedures	Countervailing Subsidy	North American Free Trade Agreement (NAFTA)
Agreement on Preshipment Inspection	Country of Origin Rules	Nullification
Agreement on the Application of Sanitary and Phytosanitary Measures (SPS)	Customs Valuation Code	Principle of Transparency
Agreement on Technical Barriers to Trade (TBT)	Dispute Settlement Body (DSB)	Safeguards
Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)	Dispute Settlement System (DSS)	Subsidies
Bali Package	Dumping	Sunset Reviews
Binding Commitments	Embargoes	Suspension
Cease and Desist Order	European Union (EU)	Tariff Act of 1930
Code on Subsidies and Countervailing Duties	Free Trade Agreements (FTAs)	Tariff Act of 1974
Countervailing Duties	General Agreement on Tariffs and Trade (GATT)	Theory of Comparative Advantage
	General Agreement on Trade in Services (GATS)	U.S. Trade Representative (USTR)
	Illegal Subsidies	Uruguay Round
	Impairment	World Trade Organization (WTO)
	Most-Favored-Nation Principle	WTO Dispute Settlement
	National Treatment Principle	WTO Panels
		Zeroing

Chapter Problems

- 1 How can the free trade mandate of the World Trade Organization (WTO) be reconciled with the concerns of labor, environmental, and consumer groups? What is meant by the word *free* in the term *free trade*? Does free mean no restrictions on the flow of labor, capital, goods, services, and technology? Should free trade be limited by other concerns such as local disruption? Should local cultural concerns be a limitation on the nonregulation of trade? How can the WTO dispute resolution and enforcement process be reconciled with a country's assertion of national sovereignty over its national laws and regulations?
- 2 The Agreement on the Application of Sanitary and Phytosanitary Measures (SPS) and the Agreement on Technical Barriers to Trade (TBT) related to national standards may act as disguised barriers to trade. What are the differences in coverage between the SPS and TBT? Can the SPS and TBT both apply to the importation of a product?
- 3 The United Nations Conference on Trade and Development (UNCTAD) asserts that the 48 poorest nations of the world, including 33 in Africa, are failing to benefit from globalization and freer trade. In fact, there is evidence that poverty is worsening in many of these countries. What can be done to improve the effect of free trade on these impoverished countries? Should the WTO take a greater role in obtaining preferential tariff treatment for goods exported from these countries? How can developed countries continue to justify protection of domestic industries such as agriculture and textiles through the granting of subsidies?
- 4 How can one reconcile restrictive immigration policies with the notion of free trade? Why should goods, services, and capital be allowed to move freely and not persons? How do the restrictive immigration laws sanctioned under NAFTA compare with the EU's "Four Freedoms" of goods,

- services, capital, and persons and the EU's movement toward EU passports and citizenship? How does one reconcile U.S. interests in "border control" with its own liberal democratic principles? How does one reconcile the call to "regain control of our borders" with the government's policy not to harass employers of illegal aliens in industries where their labor is needed? What are the ethical arguments against proposals to prohibit undocumented immigrants from receiving emergency medical care or public schooling? One argument can be found in the United States Constitution, where no distinction is made between legal and illegal immigrants in the admonition that "all [persons] are endowed by their Creator with inalienable rights."
- 5 The United States had requested that a WTO Dispute Settlement Panel review an alleged Canadian violation of the intellectual property provisions of TRIPS. The United States argued in its complaint that the TRIPS Agreement requires WTO members to grant a minimum term of protection to all patents existing as of the date of application of the Agreement, and that Canada must apply the Agreement as of January 1, 1996. Canada's Patent Act provides that patent applications filed before October 1, 1989 would receive patent protection for only 17 years from the date the patent is issued. Article 33 of the TRIPS Agreement requires WTO members to provide a patent protection term of at least 20 years from filing for all patents existing on January 1, 1996. Canada relied on Article 28 of the Vienna Convention, arguing that there is a presumption against retroactivity for treaties. Which country do you think won? Why?
 - 6 One can argue that regional trade areas like the European Union work like "mini-GATTs." In such systems it is inevitable that national concerns and sovereignty will conflict with the free trade dictates of the union. National subsidies traditionally given to domestic agricultural industries are one instance. France has a longstanding policy of granting aid to olive growers. Can France continue to give such aid under the auspices of the European Union? If so, does it need the permission of the EU?
 - 7 Ralph Nader and Lori Wallach had this to say about the World Trade Organization: "The binding provisions that define the WTO's functions and scope do not incorporate any environmental, health, labor, or human rights considerations. There is nothing in the institutional principles of the WTO to inject any procedural safeguards of openness, participation, or accountability. The WTO 'dispute resolution system' is the mechanism that enforces WTO control over democratic governance. WTO panel members are selected from qualifications that produce panelists with a uniformly pro-trade perspective. The new rules favor the largest, most developed nations. Unlike the old GATT rules, the new WTO requires all members to agree to be bound by all Uruguay Round accords. The rule forces many countries, usually small ones, to accept trade in areas that might be undesirable in the long run. WTO rules are now enforceable as regards all existing federal, state, and local laws. In effect, countries have voluntarily sacrificed their own sovereignty. The WTO's rules and powerful enforcement mechanism promote downward harmonization of wages, environmental, worker, and health standards. Some international trade is useful, while other global trading favors corporate advantages over those of workers, consumers, and the environment. Concentrating power in international organizations, as trade pacts do, tends to remove critical decisions from citizen control."¹³ Do you agree with Nader and Wallach's assessment of the dangers of the WTO? Do you think the dangers outweigh the benefits? What role should governments play in balancing the promotion of free trade through organizations like the WTO and the concerns addressed in the quote above?

Internet Exercises

- 1 Review recent developments in the area of trade law by reviewing the following web sites: <http://www.jus.uio.no/lm/international.economic.law/itl.html> and <http://www.ita.doc.gov> (U.S. International Trade Administration).
- 2 Read the overview of the WTO and GATT at <http://www.wto.org>.
- 3 Review recent WTO decisions that highlight the intersection between trade and environmental issues. See, for example, <http://www.worldtradelaw.net>.

Other Internet Sources

World Trade Organization: <http://www.wto.org>.

WTO documents: <http://www.worldtradelaw.net>.

Text of WTO codes and agreements: http://www.wto.org/english/docs_e/docs_e.htm.

U.S. International Trade Administration: <http://www.ita.doc.gov>.

Notes

- 1 See Alan C. Stockman, *Introduction to Economics* (2nd ed.); N. Gregory Mankiw, *Macroeconomics* (5th ed.).
- 2 “Historical trade package sealed at WTO Bali meeting,” *Global Times* (Xinhua Publisher, December 7, 2013).
- 3 John Kraus, *The GATT Negotiations: A Business Guide to the Results of the Uruguay Round*, ICC Pub. No. 533 (E) 18 (1994).
- 4 See Debra Strauss, “Feast or Famine: The Impact of the WTO Decision Favoring the U.S. Biotechnology Industry in the EU Ban of Genetically Modified Foods,” 45 *American Business Law Journal* 775 (2008).
- 5 John H. Jackson, “Helms-Burton, the U.S. and the WTO,” 2 *ASIL Insights* (March 3, 1997).
- 6 See Michael J. Trebilcock, *International Trade Law* (2015).
- 7 Source: World Trade Organization.
- 8 In the area of services, the WTO has developed a “Services Sectoral Classification List” that identifies service sectors.
- 9 19 U.S.C. § 1677.
- 10 Sungjoon Cho, “No More Zeroing? The United States Changes its Antidumping Policy to Comply with the WTO,” 16 *ASIL Insights* (March 9, 2012).
- 11 See Section 301 at 19 U.S.C. §§ 2411-19 (1994).
- 12 Stephen L. Kass and Jean M. McCarroll, “Having it All: Trade, Development, Environmental, and Human Rights,” *New York Law Journal* (May 5, 2000).
- 13 Ralph Nader and Lori Wallach, “GATT, NAFTA, and the Subversion of the Democratic Process” at <http://www3.uakron.edu/worldciv/pascher/nader.html>.

NATIONAL IMPORT AND EXPORT REGULATION

Countries' export and import regulations directly impact an exporter or importer's ability to undertake profitable international trade transactions. National regulation may bar an exporter's ability to honor a contract if he is precluded from exporting his goods. Also, the cost of importing can be dramatically changed in the event that the duties assigned to a transaction through customs regulations are different from what was expected by the importer. This chapter addresses the relationship between U.S. customs regulations and private business transactions. Does the typical U.S. exporter need to be concerned with violating U.S. export regulations? What do U.S. export regulations demand of the exporter? What are the consequences for violating the regulations?

In importing, the assessment of duties and marking requirements are crucial. A miscalculation of duty owed to the government of import could convert an otherwise profitable import transaction into a loss. In addition to duties, penalties for violating the customs laws can be substantial. Failure to conform to a country's marking or country-of-origin requirements can result in the goods being barred from importation. This chapter is divided into two parts. The first reviews the process of importing goods into a country with a primary focus on U.S. import requirements and restrictions. The second part reviews the law relating to the exporting of goods from the U.S. Most countries have similar processes, requirements, and restrictions.

Import Requirements and Duties

In order to import goods into a foreign country, the importer must satisfy a number of requirements. The three basic types of laws that regulate the importation of goods include: (1) assessment of duties, (2) marking requirements, and (3) standards requirements. Unlike in export regulation, which tends to be more country-specific, there is general agreement among most countries on how to classify goods and assess import duties. The fundamental factors used to determine the customs duties are classification, valuation, and country of origin. Duties vary with the type of goods, their value, and where they originated.

The classification of the type of good being imported is determined by the application of the **harmonized tariff schedule (HTS)**. The **World Customs Organization (WCO)** publishes the HTS, which is used by WTO member countries. The U.S. International Trade Commission (ITC) publishes the U.S. version of the HTS. All goods imported into the United States are subject to the provisions of the HTS. The HTS classification number determines the duty rate to be applied to imported goods.

The **country of origin** determination is made to determine if the goods are subject to a WTO's most-favored-nation rate, NAFTA (North American Free Trade Agreement) rate, or a rate provided by the **generalized system of preferences (GSP)**. The GSP is a framework under which developed countries give preferential tariff treatment to manufactured goods imported from developing countries. HTS classification consists of a series of numbers that identify categories of goods beginning with broad categories. As numbers are added, the description becomes increasingly more specific. The HTS uses the following groupings: section, chapter, heading, and subheading. Twenty-two sections broadly cover products from different industries; 99 chapters group products by industry ranging from agricultural and component products to finished products. Each grouping is represented by a series of numbers. The first six digits of a tariff classification, uniform for all countries using the WCO system, represent the

chapter and heading levels. The first two digits refer to the chapter, and the next four to the heading and sub-headings. Countries may add more detail by using an additional four digits. In the U.S., digits seven and eight denote tariff items and digits nine and ten are used for statistical purposes.

World Customs Organization makes changes and publishes the HTS. However, each country must then adopt the changes to conform its HTS to the WCO's HTS. WCO member countries are responsible for 98 percent of all international trade

The U.S. HTS is divided into 22 sections and 99 chapters, as well as a number of appendices. The 22 sections divide imports into the following categories:

Section 1: Live Animals, Animal Products	Section 12: Footwear, Umbrellas, Whips
Section 2: Vegetable Products	Section 13: Stone, Plaster, Cement, Ceramic
Section 3: Animal or Vegetable Oils, Fats	Section 14: Pearls, Precious Metals, Jewels
Section 4: Prepared Foodstuffs, Alcohol	Section 15: Base Metals
Section 5: Mineral Products	Section 16: Machinery, Appliances
Section 6: Chemicals Products	Section 17: Vehicles, Boats, Aircraft
Section 7: Plastics and Rubber	Section 18: Watches, Other Instruments
Section 8: Hides, Skins, Furs, Handbags	Section 19: Arms and Ammunition
Section 9: Wood, Cork, Straw, Baskets	Section 20: Manufactured Articles
Section 10: Pulp and Paper Products	Section 21: Works of Art
Section 11: Textile and Textile Products	Section 22: Special Classifications

The HTS published by the ITC is about 3,526 pages in length, which demonstrates the high degree of specificity that is expected in classifying imported goods. It is the responsibility of the importer to select the proper classification number subject to review of the U.S. customs authorities. Given the variety of classification choices, importers are often tempted to select a classification number with the lowest tariff rate. However, the HTS provides rules of interpretation, found below in Figure 6.1 *Focus on Transactions*: “Clothing Not Knitted or Crocheted,” which provides an example of how the HTS classification system is applied. The rules of interpretation must be followed in selecting the classification of the goods to be imported. Failure to do so could lead to a delay in the importation and fines.

A review of how the HTS works follows, using the HTS page below. The HTS has seven columns. Column 1 provides the heading and subheading for the goods being classified. The different numbered headings essentially make up the HTS classification number. Column 3 provides a description of the goods. The first description given is at the “heading level.” This heading provides a “general description” of the goods covered by the heading. Its description states: “Men’s or boys’ overcoats, carcoats, capes, cloaks, anoraks (including ski-jackets), windbreakers

The HTS classification system is detailed and complex. For examples, Section 11 on Textiles contains 14 chapters or general product classifications: Silk; Wool and Animal Hair; Cotton Silk; Vegetable Fibers and Paper Yarn; Man-Made Filaments; Man-Made Fibers; Wadding and Ropes; Carpets; Woven Fabrics, Lace, and Tapestries; Laminated and Industrial Textiles; Knitted

or Crocheted Fabrics; Clothing (Knitted or Crocheted); Clothing (not Knitted or Crocheted); and Other Textile Articles and Rags. To go a step further, there are 414 headings and subheadings in the schedule for Chapter 61, including one entitled “Clothing (not Knitted or Crocheted).” The first page of that Chapter is provided below.

Figure 6.1 *Focus on Transactions*: “Clothing Not Knitted or Crocheted.”

NATIONAL IMPORT AND EXPORT REGULATION

Table 6.1 HTS, Section 11, Chapter 61, page 1 of 73 (<http://hts.usitc.gov>)

Heading Subheading	Stat Suffix	Article Description	Unit or Qty	General Duty Rate	1 Special Duty Rate	2
6101		Men's or boys' overcoats, car-coats, capes, cloaks, anoraks (including ski-jackets), windbreakers and similar articles			Free: (AU, BH, CA, CL, IL, JO, KR, MA, MX, OM, P, PA, PE, SG)	50%
6101.20.00		Of cotton		15.9%		
	10	Men's (334)	doz./kg			
	20	Boy's (334)	doz./kg			
6101.30		Of manmade fibers				
6101.30.10	00	Containing 25 percent or more by weight of leather (634)	doz./kg	5.6%	Free: (AU, BH, CA, CL, IL, JO, KR, MA, MX, OM, PA, PE, SG)	35%
		Other:				
6101.30.15	00	Containing 23 percent or more by weight of wool or fine animal hair (434)	doz./kg	38 cents/kg + 10%	Free: Same as above	77 cents/kg + 54.5%
6101.30.20		Other			Free: Same as above	72%
	10	Men's (634)	doz./kg			
	20	Boys' (634)	doz./kg			
6101.90		Of other textile materials:				
6101.90.05	00	Of wool or fine animal hair (434)	doz./kg	61 cents/kg + 16%	Free: Same as above, except OM	77 cents/kg + 54.5%
					18.5 cents/kg + 4.8%	
6101.90.10	00	Containing 70 percent or more by weight of silk or silk waste (734)	doz./kg	0.9%	Free: Same as above	45%
6101.90.90		Other		5.7%	Free: Same as above	45%
	10	Subject to cotton restraints (334)	doz./kg			
	20	Subject to wool restraints (434)	doz./kg			
	30	Subject to man-made fiber restraints (634)	doz./kg			
	60	Other (834)	doz./kg			

and similar articles.” This is where the importer begins by finding the heading that best describes the goods being imported. The importer then scrolls down the HTS viewing all the subheadings that differentiate goods covered by the heading. Goods are differentiated based upon whether the garment is made for “men” or “boys” and by the type of material used to make the garment (cotton, man-made fibers, other textile material, such as wool). Column 2 “Stat Suffix” provides access to all the rulings relating to the specific heading or subheadings, such as sample rulings (letter) shown in Figure 6.2. This provides an archive that the importer can research if unclear on something related to a specific classification. If there is no relevant ruling, then the importer can either determine a reasonable classification or ask the CBP (U.S. Customs and Border Protection) for a ruling on the importer’s question or selection of a classification. Seeking a ruling is the correct course of action if the importer is unsure of a reasonable classification and a misclassification could result in much higher duties being assessed.

Column 4 provides the amount or number of items being imported. Since the product is clothing, the amount being imported is measured by number of items (dozens) or weight of the items (kilograms). Column 5 is the *general duty rate*, which is the rate given to all WTO members based on the most-favored-nation principle.

Table 6.2 GSP Countries

Algeria	Mexico
Argentina	Morocco
Bangladesh	Mozambique
Benin	Myanmar
Bolivia	Nicaragua
Brazil	Nigeria
Cameroon	North Korea
Chile	Pakistan
Colombia	Peru
Cuba	Philippines
Ecuador	Singapore
Egypt	South Korea
Ghana	Sri Lanka
Guinea	Sudan
Guyana	Tanzania
India	Thailand
Indonesia	Trinidad & Tobago
Iran	Tunisia
Iraq	Venezuela
Libya	Vietnam
Macedonia	Zimbabwe
Malaysia	* MERCOSUR

* MERCOSUR is a sub-regional trade group consisting of Argentina, Brazil, Paraguay, Uruguay, and Venezuela, with associate countries that include Bolivia, Chile, Colombia, Ecuador, Peru, and Suriname.

Column 6 is the lower or preferential rates provided by the GSP to less developed countries or due to a free trade agreement. See the above list of GSP-designated countries.

The countries are designated by their country codes provided in Annex B of the HTS. In our example, the preferred countries include: AU (Australia), BH (Bahrain), CA (Canada), CH (Chile), IL (Israel), JO (Jordan), KR (South Korea), MA (Morocco), MX (Mexico), OM (Oman), PA (Panama), PE (Peru), and SG (Singapore). All of these countries have free trade agreements with the U.S., which have lowered tariff rates to “free” or zero. Elsewhere in the HTS the non–most-favored-nation rates reach as high as 100 percent (column 7). These types of exorbitant rates are meant to punish an exporting country and effectively prevent the importation of goods from that country. More positively stated, the rates show the major benefits obtained through WTO membership. The above example shows the two exceptions to the WTO’s most-favored-nation principle in which lower tariffs can be given to some countries and not others: free trade agreements and GSP. In looking at the 6101 part of Chapter 61, depending on the item and the country of export, the tariff could be as little as 0 percent. This information is found in the column entitled “Special Duty Rate.”

General and Additional Rules of Interpretation

The U.S. HTS Rules of Interpretation for selecting the proper classification of a product are rather simplistic, consisting of one page of *general rules* and a one-half page of *additional rules*. However, the brevity of the rules of interpretation belies the complexity of the classification determination. The rules of interpretation are followed by 937 pages of “notes” that provide definitions for interpreting the many chapters of the HTS. The “notes” consist of thousands of headings and subheadings (classifications), as well as rules for adjusting tariff rates relating to free trade agreements, such as NAFTA and preferential rates for less developed countries (GSP).

General Rules of Interpretation

Classification of goods in the tariff schedule shall be governed by the following principles:

- 1 The chosen HTS classification must have the essential character of the complete or finished article. The classification should state that the article is complete or finished, or alternatively as unassembled or disassembled.
- 2 The classification of goods consisting of a mixture or combination of materials shall be taken to include a reference to goods consisting wholly or partly of such material. The classification of goods consisting of more than one material shall be made in accordance with rule 3.
- 3 When goods are, *prima facie*, classifiable under two or more headings, classification shall be selected as follows:
 - a The heading that provides the most specific description shall be preferred to headings providing a more general description. However, when two or more headings apply to mixed or composite goods, those headings are to be regarded as equally specific in relation to those goods.
 - b Mixtures and composite goods consisting of different materials or made up of different components, which cannot be classified by reference to 3(a), shall be classified based on the material or component, which gives them their essential character.
 - c When goods cannot be classified by reference to 3(a) or 3(b), they shall be classified under the heading which occurs last in numerical order among those which equally merit consideration.
- 4 Goods that cannot be classified in accordance with the above rules shall be classified under the heading appropriate to the goods to which they are most akin.
- 5 ...
- 6 For legal purposes, the classification of goods in the subheadings of a heading shall be determined according to the terms of those subheadings and *mutatis mutandis*, to the above rules, on the understanding that only subheadings at the same level are comparable.

Mutatis mutandis: Latin for “the necessary changes having been made.” In the above case, it means that when determining the appropriate subheadings, the same rules (Rules 1–4) used to determine headings shall be used to determine the appropriate subheading, but only between subheadings under the same heading, but not in trying to compare subheadings under different headings.

Additional Rules of Interpretation

The additional rules of interpretation provide an alternative method of classifying goods by focusing on the *principal use* of the good: “Tariff classification is determined by the use of the goods at the date of importation. The use intended at the time of importation is the use the goods are actually so used.” Proof must be provided within three years after the date the goods are entered.

Companies may ask for a ruling letter from CBP. A ruling letter may address the tariff classification or appraised value of merchandise, the liquidation of an entry, or the exclusion of merchandise from entry. As such, ruling letters facilitate trade by enabling companies to make business decisions that are dependent on how their goods will be treated on importation. See Figure 6.2: “Sample Letter” issued by the CBP.

The rules of interpretation recognize that there is often no exact fit between the good being imported and a HTS tariff classification. When more than one tariff selection is possible, the rules are the means by which the importer and CBP make the final selection. The primary rule of interpretation is the **rule of specificity**. It requires the use of a heading and subheading that provides a more specific description of the good over one that gives a more general

August 26, 1999
 CLA-2-62: RR: NC: WA: 357 E85138
 CATEGORY: Classification
 TARIFF NO.: 6202.91.1000
 Ms. Jeannine Smith, Sammie Bauer, Inc.
 RE: The tariff classification of a woman's padded sleeveless jacket from China
 Dear Ms. Smith:
 In your letter dated August 2, 1999, you requested a classification ruling.
 The sample submitted, style number 23904122, is a woman's hip-length reversible padded sleeveless jacket. One side of the garment is constructed of a knit 100% polyester fleece fabric that is quilted in a diamond pattern to a nonwoven batting fill. The other side is

constructed of a woven plaid 85% wool/15% nylon fabric. The garment will be imported under item number 008-0272 in regular sizes, under item number 008-0273 in petite sizes and under item number 008-0274 in tall sizes. The garment features a V-neck style collar and oversized armholes. The garment has a full front opening that is secured by a left-over-right two-button closure on the knit fabric side and by a right-over-left two-button closure on the woven fabric side. The woven fabric side of the garment has two front patch pockets at the waist. The garment is bound at the edges by piping composed of a knit polyester fleece fabric. Although this garment has a left-over-right button closure on the knit fabric side, the cutting specifications that you submitted for the garment clearly indicate that it is designed for a woman. The sample is being returned to you as you have requested.

Figure 6.2 Sample Letter (HTS Classification) (Issued by CBP).

description. If neither description is considered more specific, then the heading for the material, component, or function (principal use of the good) that provides the **essential character** of the good is to be used.

Over time, as more headings are added to the HTS, the rule of specificity and the essential character rule may result in a change of classification for a specific product. A change of classification may result in a different duty rate being applied, so it is important for importers to keep up to date on changes or additions made to the HTS. The need for additions to tariff classifications is especially apparent in the area of technology products.

Bureau of Customs and Border Protection (CBP), formerly the U.S. Customs Service, is the largest enforcement agency in the U.S. with over 45,000 agents and officers. The CBP is part of the Department of Homeland Security (DHS). Another agency of the DHS charged with enforcing immigration law is the **Immigration and Customs Enforcement (ICE)**, formerly the U.S. Immigration and Naturalization Service (INS), which had been within the Department of Justice. The Homeland Security Act of 2002 created the CBP and ICE as parts of the new Department of Homeland Security. This restructuring was a response to the terrorists' attacks of September 11, 2001.

The general rule-making authority in customs classification and assessment of duties in the United States is vested in the CBP. U.S. courts will generally defer to CBP rule-making authority when the Tariff Law is unclear. The Supreme Court in the *United States v. Haggard Apparel Co.* case that follows held that the courts will grant deference to the CBP when it writes regulations that clarify parts of the tariff statutes that are unclear as to particular goods or services. So long as the CBP is reasonable in its interpretation, its rules should stand. The *Haggard* case also exposes the reader to *Section 9802* of the HTS (see p.179 on "Section 9802"), which provides a special exemption from tariff duties for items temporarily exported for assembly and then returned to the United States.

United States v. Haggard Apparel Company

526 U.S. 380 (1999)

Justice Kennedy. This case concerns regulations relating to the customs classification of certain imported goods issued by the U.S. Customs Service (now known as

Customs and Border Protection or CBP). The question is whether these regulations are entitled to judicial deference in a refund suit brought in the Court of International

Trade (CIT). Contrary to the position of that Court and the Court of Appeals, we hold the regulation in question is subject to the analysis required by *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, and that if it is a reasonable interpretation and implementation of an ambiguous statutory provision, it must be given judicial deference.

Chevron Doctrine: In *Chevron USA v. Natural Resources Defense Council*, 467 U.S. 837 (1984), the U.S. Supreme Court held that decisions and regulations of Federal government agencies are to be given deference as long as the agency's interpretation is "permissible" under the Statute that it is interpreting. A party challenging an agency decision or regulation has a heavy burden of proof to show that the agency's interpretation was unreasonable.

Respondent Haggard Apparel Co. designs, manufactures, and markets apparel for men. This matter arises from a refund proceeding for duties imposed on men's trousers shipped by respondent to this country from an assembly plant it controlled in Mexico. The fabric had been cut in the U.S. and then shipped to Mexico, along with the thread, buttons, and zippers necessary to complete the garments. There the trousers were sewn and reshipped to the U.S. If this case involved mere assembly without other steps, the imported garments would have been eligible for the duty exemption, which respondent claims.

Respondent, however, in the Government's view, added one other step at the Mexican plant: permapressing. Permapressing is designed to maintain a garment's crease in the desired place and to avoid other creases or wrinkles that detract from its proper appearance. The CBP claimed the process permapressing was an added process in addition to assembly, and denied a duty exemption; respondent claimed the baking was simply part of the assembly process or an "operation incidental to the assembly process." The CIT ruled in favor of respondent. On review, the Court of Appeals affirmed.

Section 9802 provides importers a partial exemption from duties otherwise imposed:

Any significant process, operation, or treatment other than assembly whose primary purpose is the fabrication, completion, physical or chemical improvement of a component, or which is not

related to the assembly process, whether or not it effects a substantial transformation of the article, shall not be regarded as incidental to the assembly and shall preclude the application of the exemption to such article. The following is an example of operations not considered incidental to the assembly: chemical treatment of components or assembled articles to impart new characteristics, such as showerproofing, permapressing, dying, or bleaching of textiles.

The CBP is responsible for the proper classification of imported goods under the tariff schedules (HTS).

The statutes authorizing customs classification regulations are consistent with the usual rule that regulations of an administering agency warrant judicial deference. The Court of Appeals held in this case, and in previous cases presenting the issue, that these regulations were not entitled to deference because the Court of International Trade is charged to "reach the correct decision" in determining the proper classification of goods. Deference to an agency's expertise in construing a statutory command is not inconsistent with reaching a correct decision. If the agency's statutory interpretation fills a gap or defines a term in a way that is reasonable in light of the legislature's revealed design, we give that judgment controlling weight.

The customs regulations may not be disregarded. Application of the *Chevron* framework is the beginning of the legal analysis. Like other courts, the Court of International Trade must, when appropriate, give customs regulations *Chevron* deference. VACATED and REMANDED.

Case Highlights

- The Court of International Trade is the U.S. court that has jurisdiction over any civil matters against the U.S. arising out of federal laws governing import transactions. The court hears cases dealing with anti-dumping, product classification, valuation, and countervailing duty matters.
- Permapressing clothes are not assembly under Section 9802 or an "operation incidental to the assembly process."
- Merely because a process, operation, or treatment fails to produce a *substantial transformation* does not automatically result in it being able to obtain a duty exemption under Section 9802.
- Courts must give deference to the regulations published by the Customs Service (CBP).

The *United States v. Haggar* case dealt with the relationship between an executive branch agency (CBP, previously called the Customs Service) and the courts. Another issue is the ability of individual states to enact laws that may impact international trade. The *National Foreign Trade Council v. Baker* case deals with a state statute limiting the procurement of goods from the country of Myanmar.

National Foreign Trade Council v. Baker

26 F. Supp. 2d 287 D.C. Mass. (1998)

Tauro, District Judge. Plaintiff National Foreign Trade Council (NFTC) brings this action against the Commonwealth of Massachusetts seeking a declaratory judgment that the “Massachusetts Burma Law” is unconstitutional. The “Burma Law” is a procurement statute that prohibits the Commonwealth from purchasing goods or services from anyone doing business with the country of Myanmar (formerly Burma). Plaintiff claims that the Burma Law is invalid because it: (1) intrudes on the federal government’s exclusive power to regulate foreign affairs; (2) discriminates against and burdens international trade in violation of the Foreign Commerce Clause; and (3) it is preempted by a federal statute and an executive order imposing sanctions on Myanmar.

Under our constitutional framework, the federal government has exclusive authority to conduct foreign affairs. The Court has admonished, “Power over external affairs is not shared by the States; it is vested in the national government exclusively.” The Commonwealth concedes that the statute was enacted solely to sanction Myanmar for human rights violations and to change Myanmar’s domestic policies. Therefore, Massachusetts’ Burma Law unconstitutionally impinges on the federal government’s exclusive authority to regulate foreign affairs.

“Buy American” statutes can be distinguished because their whole purpose and effect is to promote economic development at home. They do not single out a particular foreign country for particular treatment, as does the Massachusetts Burma Law. However, at least one court has held that even Buy American statutes may violate the foreign affairs doctrine. The court in *Bethlehem Steel Corp. v. Board of Comm’n*, 80 Cal. Rptr. 800 (1969) held unconstitutional a California “Buy American Law” that awarded state construction contracts only to companies that agreed to use American-made products.

Under the foreign affairs doctrine, the proper forum to raise such concerns is the United States Congress. Plaintiff’s Motion for Summary Judgment is **AFFIRMED**.

Case Highlights

- The **foreign affairs doctrine** states that it is the exclusive domain of the federal government to enact laws regulating international trade.
- A state law that prohibits the procurement of goods from a particular country is an unconstitutional intrusion of federal government powers.

Buy Domestic Goods Laws

The Buy American laws should not be confused with Buy American marketing campaigns that urge consumers to buy products “Made in America.” These laws restrict government procurement of foreign-made goods. They are found at the federal, state, and municipal levels of government. Congress passed the first *Buy American Act* in 1933 in the context of the Great Depression and states that the U.S. government is “to prefer U.S.-made products in its purchases.” In 1983, the U.S. passed the *Buy America Act*, which applies to mass-transit-related procurements valued over US\$100,000 and funded at least in part by federal grants.

The *National Foreign Trade Council v. Baker* was decided on constitutional grounds. Wouldn’t the law also violate the “national treatment principle” of the WTO? The *Baker* court also implied that “Buy American” laws were different because they “do not single out a particular foreign country for particular treatment.” The court noted the Pennsylvania Buy American Act requires government agencies to only buy steel from American companies as an example. This is an illogical proposition since even though it applies to all countries’ steel exports, in fact, there are only a few countries that import steel into the U.S. in substantial amounts. To think that the act doesn’t discriminate against those countries is absurd. Such laws violate the national treatment principle, but do they violate

the WTO Agreements? The answer lies in the fact that the WTO Agreements include the Agreement on Government Procurement, which excludes the Buy American Acts from its coverage.

However, the sweep of the Buy American laws is greatly diminished for two reasons. First, the Acts provide a number of exceptions that allow for the purchase of foreign products: (a) if the domestic product is more expensive than an identical foreign-sourced product by a certain percentage, (b) if the product is not available domestically in sufficient quantity or quality, or (c) if doing so is in the public interest. Second, more recent FTAs (free trade agreements) have preempted the application of the federal law to the other countries that are party to the FTA. Under NAFTA, Canadian and Mexican goods are exempt from these requirements if procurement is by a U.S. federal department or agency and if the value of procurement exceeds \$25,000 for goods, \$79,507 for services, and \$10,335,931 for construction services.

Assessment of Duties

The amount of customs duties to be paid is an important factor that must be analyzed before any long-term contract is signed. An import duty is a tax imposed on imports by a customs authority. Duties are generally based on the value of the goods (***ad valorem* duties**); some other factors include weight or quantity (***specific* duties**), or a combination (compound duties). *Ad valorem* literally means “according to value” and refers to any charge, duty, or tax that is applied as a percentage of value. The assessment of import tariffs or duties is a product of three variables: (1) classification of the goods being imported, (2) valuation of the goods, and (3) the country of origin. Figure 6.3 *Focus on Transactions*: “The Dutiable Status of Goods” outlines the factors involved in applying these three elements in determining the amount of duties, if any, owed on imported goods.

Dutiable Status is the CBP determination of the amount of duty (tax) owed by the importer. The below three columns summarize the factors used in calculating the duty owed. Column 1 (Classification) and Column 3 (Country of Origin) determine

the rate (%). Column 2 (Valuation) determines the value of the imported goods. The value of the goods is then multiplied by the rate to determine duty owed.

Figure 6.3 *Focus on Transactions*: Dutiable Status of Goods.

CLASSIFICATION +	VALUATION +	COUNTRY OF ORIGIN
Harmonized Tariff Schedule Rules of Interpretation: Common/Commercial Meaning Rule of Relative Specificity Essential Character Principal Principal Use Rule Latest Entry Rule Doctrine of the Entireties Chief Weight Rule (Textiles)	Transaction Value Price paid Packing Costs Commissions (by buyer) Value of “Assists” Royalties/Fees (by buyer) Proceeds of Resale (accruing to seller)	“Rules-of-Origin” Grown, mined, produced, manufactured “Substantial Transformation Test” <ul style="list-style-type: none"> • new article • value added • process versus assembly • producer to consumer good

Section 9802

The *United States v. Haggar* case introduced Section 9802, which allows importers to deduct the value of assembly from duty assessment. This exemption is given for “articles assembled abroad in whole or in part of fabricated components that are products of the United States.” It also extends the exemption to any advancement in value or



Image 6.1 Maquiladora Factory.

improvement in condition that is a result of “operations incidental to the assembly process such as cleaning, lubricating, and painting.” This exemption has resulted in the creation of a corridor of assembly plants, popularly known as *maquiladoras*, along the United States–Mexico border. **Maquiladora** or “in-bond” industry allows foreign importers to ship components into Mexico duty-free for assembly and reexport. The key issue of contention between the CBP and importers is the definition of “fabrication.”

Maquiladora (or *maquila*) is a manufacturing operation in a free trade zone (FTZ), where companies import material and equipment on a duty- and tariff-free basis for assembly, processing, or manufacturing. The assembled, processed, or manufactured products are then usually exported back to the country of origin.

The Mexican Border Industrialization Program helped create the maquiladora industry by attracting foreign investment. To do that, Mexican labor is kept cheap and competitive with other major export countries, but the treatment of the workers in these plants along the Mexican–American border raises grave ethical issues since:

- The majority of *maquiladora* employees are young women. Women are preferred to men because women typically work more.
- Women are often subjected to unsafe and unsanitary working conditions.
- Poverty is a key factor that motivates women, in particular, to work in maquiladoras.
- The minimum wage set by the Mexican government is barely enough to help sustain a family.
- Both the United States and Mexican governments claim to be committed to environmental protection, yet environmental policies have not always been enforced.
- The *La Paz* Agreement signed by Mexico and the United States in 1983 requires hazardous waste created by U.S. corporations to be transported back to the U.S. for disposal. Instead, most companies avoid paying disposal costs by dumping toxins and other waste into Mexico’s rivers or deserts.
- Streams and rivers in the border region have been ecologically devastated as a consequence of the *maquila* industry. However, much of this damage is likely caused by the Mexican government’s failure to invest in sewage treatment infrastructure. These facts raise a number of important questions: (1) How should the economic benefits of attracting foreign investments be balanced against the marginal improvements of the workers’ quality of life? (2) Is the argument that the jobs created by the *maquiladora* industry are better than no jobs at all the ultimate winning argument? (3) Is that the only question to be asked—jobs versus no jobs—or does corporate social responsibility provide other questions? (4) Do American companies pay a “living wage,” which would still be dramatically lower than the hourly wage paid to American workers? (5) Does the fact that other countries are competing with Mexico as low-cost havens for outsourcing change the calculation? (6) Who is ultimately responsible for the environmental disaster and its cleanup?

Figure 6.4 Focus on Ethics: Ethics Issues of Maquiladora Industry.

The term *maquiladora* in the Spanish language refers to the practice of millers charging a *maquila* or “millers” portion for processing other people’s grain.

The *maquiladora* factories produce about one-half of Mexico’s exports. The ethical issues related to the *maquiladora* industry are introduced in *Focus on Ethics*: “Ethics Issues of *Maquiladora* Industry.”

In *Samsonite Corp. v. United States* the CBP successfully challenged an importer’s deduction for the value of assembling luggage in Mexico. Steel strips were produced in the United States and then sent to the company’s assembly plant in Mexico. The case involved the deductibility of the costs of the steel strips upon importation into the United States. The Court agreed with the Customs Service (CBP) that shaping the steel strips before placing them within the luggage constituted a further fabrication and not mere assembly.

Samsonite Corp. v. United States

889 F.2d 1074 (Fed. Cir. 1989)

Friedman, Senior Circuit Judge. This is an appeal from a judgment of the United States Court of International Trade upholding the denial by the Customs Service of a deduction from assessed duties of the cost of an item that had been manufactured in the United States and, after undergoing certain changes in Mexico, was incorporated into the finished product shipped from Mexico to the United States. The Court of International Trade described the metal strips and Samsonite’s use of them in assembling the luggage as follows: “When they left Tucson, the strips were straight, approximately 1–7/8 inches wide and 55 inches long. After arrival at plaintiff’s assembly facility in Nogales, the strips were bent by machine into a squared-sided form and riveted on the open outsides to sheets of plastic, which thereby became the bottom plates of completed frame assemblies.”

The Customs Service classified the imported merchandise as luggage under Item 706.62 of the Tariff Schedules of the United States and assessed the 20 percent *ad valorem* duty that that item provides, less the cost or value of certain components of the luggage that had been manufactured in the United States. The latter deduction was made pursuant to Item 807.00 of those schedules. The Customs Service denied a deduction from the value of the luggage for the cost of the steel strips. The Court of International Trade upheld Customs’ denial of the deduction.

The court held that the steel strips “were not exported in condition ready for assembly.” It found that the “bending process” to which the strips were subjected “did more than ‘adjust’ the article.” The process created

the component to be assembled, which was the essence of its configuration. Without the resultant shape, the plastic plate could not be attached so as to constitute the bottom, and the completed frames could not be inserted into plaintiff’s bags, thereby imparting the intended overall form and structural stability of the finished luggage.”

To obtain a deduction for American-fabricated articles assembled abroad, the components (1) must have been exported from the United States “in condition ready for assembly without further fabrication”; (2) not have lost their physical identity in the articles by change in form, shape, or otherwise; and (3) not have been advanced in value or improved in condition “except by being assembled” and except “by operations incidental to the assembly process such as cleaning, lubricating, and painting.” The critical inquiry is whether the bending and shaping that the strips underwent constituted “fabrication” or mere assembly and operations incidental to the assembly process. We hold that what was done to the strips in Mexico was fabrication and not mere assembly. The judgment of the Court of International Trade dismissing the action is **AFFIRMED**.

Case Highlights

- In order to obtain the duty exemption for offshore assembly found in Section 9802, the exported items must be ready for assembly without further fabrication.
- The “bending process” to which the strips were subjected to in *Samsonite* “did more than ‘adjust’ the article” and thereby constituted further fabrication.

Transaction Value

Section 402 of the Tariff Act of 1930, and subsequently its amendment due to adoption of the WTO's *Valuation Code*, provides the basic method for determining the value of goods for customs purposes. The Valuations Code uses the concept of **transaction value** as the basis of customs valuation. Transaction value requires that the value of imported goods be determined on a *commercially realistic basis*. This means goods must be priced at a value that would be the result of a sale between two unrelated parties in the ordinary course of business. The valuation of goods is based upon the calculation of transaction value—namely the costs of the goods to the importer. It is in the interest of the importer to keep the transaction value as low as possible and so conflict may arise over what items of costs should be included in the transaction values. The items most contested include commissions paid by the buyer,¹ royalties or fees paid by the buyer after importation,² the value of *assists*³ (material, equipment, or services provided to seller by the buyer), and proceeds of resales paid to the original seller.

Transaction value in a transaction occurring partly in a FTZ may be difficult to determine because the import transaction is not the product of an arm's length sale, as would be the case, for example, for a transfer of raw materials or inventory between affiliated companies. The Tariff Act provides four alternative valuation methods when an arm's length transaction is not present. These alternative methods are to be followed in order of preference. The most preferred method is to use the transaction value of identical goods. This is the price charged by the same manufacturer or importer to an unrelated customer. If there is no such information available, then the second valuation method that looks at the transaction value of similar goods is to be used. This would be the price charged for nearly identical goods sold by the same manufacturer.

The third preferred alternative valuation method is the use of the **deductive value** of the goods. The deductive value is the price that the goods being imported are ultimately sold at in the U.S. The importer is allowed to *deduct* a number of costs from that price, including international freight, duties, and certain commissions. For example, foreign inland freight costs can be deducted but only if they are separately invoiced. Purchasing goods using the "ex-factory" trade term (see the discussion of INCOTERMS 2010 in Chapter 14) will remove the costs of inland shipment. Although selling commissions are included in determining dutiable value, commissions paid by the buyer are not dutiable. Therefore, by proving that any middleman is acting as the buyer's purchasing agent, the buyer's commission can be excluded from the valuation.

In order to reduce the transaction value and hence the amount of tariff duties, a sophisticated importer will attempt to *unbundle* the import transaction into dutiable and non-dutiable parts. If goods are purchased on credit that requires the payment of interest, the importer should separate the credit part of the sale from the sale of goods. If the price of goods reflects the interest charged by the seller, then the interest becomes part of dutiable value. In contrast, interest alone is not dutiable. Another example of unbundling is when an import contract provides for an inspection of goods at the port of shipment. If the seller obtains and pays for an inspection certificate as part of the documentary transaction, those costs are included in the transaction value, but inspection services paid for by the buyer are not part of the transaction value.

The final, least-preferred alternative valuation method is the **computed value** of the goods. This value is fabricated by adding the manufacturer's actual labor and material costs, along with an estimate of its general expenses and profits. The *Orbisphere Corp. v. United States* case that follows explores the concept of deductive value and the types of expenses that may be deducted before duties are assessed.

Orbisphere Corp. v. United States

765 F. Supp. 1087 (Ct. Int'l Trade 1991)

Musgrave, Judge. Plaintiff contests certain aspects of the Customs Service's valuation of plaintiff's products. Plaintiff alleges that in revaluing its merchandise on the basis of the "deductive value" of that merchandise, as

ordered by the Court and as opposed to the earlier valuation on the basis of "transaction value," Customs improperly failed to subtract from the deductive value amounts of certain commissions, profits, and expenses

involved in the sales as required by statute. Defendant argues that its failure to subtract those amounts was justified because the three items at issue—commissions, profits, and expenses—did not qualify as deductible under the applicable statute.

Section 1401a(d)(2)(A)(i), under which the merchandise was appraised pursuant to the earlier opinion, defines “deductive value” as “the unit price at which the merchandise concerned is sold in the greatest aggregate quantity at or about the date of importation.” Paragraph (3)(A) of that section prescribes a number of downward adjustments to the unit price stated above, including the following at issue in this case: “The price determined under paragraph (2) shall be reduced by an amount equal to any commission actually paid or agreed to be paid, or the addition usually made for profit and general expenses, in connection with sales in the United States of imported merchandise that is of the same class or kind, regardless of the country of exportation.”

Paragraph 3 also provides that “the deduction made for profit and general expenses shall be based upon the importer’s profit and general expenses, unless such profits and general expenses are inconsistent with those reflected in sales in the United States of imported merchandise of the same class or kind, in which case the deduction shall be based on the usual profit and general expenses reflected in such sales, as determined from sufficient information.” The principal question concerning this section in the present case is what kind of connection must be shown between the items of expenses or profits to be deducted and the U.S. sales of the imported merchandise.

The rule emanating from these decisions concerning the requisite connection between the expenses to be deducted from the import sales price and the underlying sales transactions appears to be that an importer may not prove that connection by merely multiplying the amount of its total expenses by the percentage that its sales of the subject merchandise make up of its total sales. It requires a specific listing of expenses involved in, and added in the price of, sales of the particular products or line at issue. Subparagraph (B) of paragraph (3) further provides, for purposes of applying the above adjustment, that “the

deduction made for profit and general expenses shall be based upon the importer’s profits and general expenses, unless such profits and general expenses are inconsistent with those reflected in sales in the United States of imported merchandise of the same class or kind, in which case the deduction shall be based on the usual profit and general expenses reflected in such sales, as determined from sufficient information.”

The disputed expenses in the present case are:

- 1 salary and expenses for travel;
- 2 costs for “U.S. accounting services”;
- 3 costs for “U.S. legal services”;
- 4 director’s fees and expenses for travel to Geneva.

Accordingly, the Court orders that the deductive value computed by Customs for this merchandise be reduced by the amount of those expenses. The deduction for profits is provided not based on where the profits end up but in order to provide a value of the goods sold in the United States that approximates the cost of the goods before shipment, resale, and expenses associated therewith. Accordingly, it is clear that in this case, plaintiff’s profits on the sales in question should have been deducted from the deductive value of the merchandise. Therefore, Customs is hereby ordered to amend its previous calculation of the deductive value of the subject merchandise by subtracting therefrom amounts equal to plaintiff’s expenses and profits discussed herein.

Case Highlights

- Terms such as profits and expenses occurring within the United States relating to imported goods should be subtracted when using the deductive method of calculating value for purposes of duty assessment.
- Other items that may be deducted from the value of imported goods include the cost of legal services, travel expenses, and accounting costs.
- The importer of goods must show the connection between the items being deducted and the U.S. sale of the imported goods.

Customs Valuation in the European Union

The European approach to customs valuation is similar to that in the United States. EU Council Regulation 2913/92 established the European Union’s (EU’s) *Customs Code*, which bases the valuation of imported goods on the notion of transaction value or the “price actually paid” (Article 28). Article 29 provides that transaction value must be adjusted upward for any proceeds of subsequent sales that are remitted by the buyer to the exporter, directly or indirectly. Article 32 provides a list of the types of charges that must be included in transaction value.

Customs value includes the costs of packing, commission and brokerage, and royalty and license fees. Items that are not included in the customs valuation include freight charges, charges incurred subsequent to import, and finance charges (Article 33). One advantage of the EU tariff is that it is fully harmonized in the area of import licensing. **TARIC** provides rules for determining whether an import license is required for a particular good.

TARIC Code: Integrated Tariff of the European Communities is designed to show the various rules applying to specific products when imported into the EU. This includes the provisions of the HTS, but also additional provisions specified in EU law, such as tariff suspensions, tariff quotas, and tariff preferences.

It should be noted that most EU members also maintain their own country lists of goods requiring an import license.

Drawback of Customs Duties

Drawback is a form of tax relief in which a lawfully collected customs duty is refunded or remitted wholly or in part because of the particular use made of the commodity on which the duty was collected. U.S. firms that import materials or components that they process or assemble for reexport may obtain drawback refunds of all duties paid on the imported merchandise, less 1 percent to cover customs costs. This practice encourages U.S. exports by permitting exporters to compete in foreign markets without the handicap of including in their sales prices the duties paid on imported components.

The U.S. **Trade and Tariff Act of 1984** revised and expanded drawbacks. Under existing regulations several types of drawback have been authorized, but only three are of interest to most manufacturers. First, if articles manufactured in the U.S. using imported merchandise are exported, then the duties paid on the imported merchandise may be refunded as a drawback. Second, if both imported merchandise and domestic merchandise of the same kind and quality are used to manufacture articles, some of which are exported, then duties paid on the imported merchandise are refundable as a drawback, regardless of whether that merchandise was used in the exported articles.

Finally, if articles of foreign origin imported for consumption are exported from the United States or are destroyed under the supervision of the CBP within three years of the date of importation, in the same condition as when imported and without being “used” in the United States, then duties paid on the imported merchandise are refundable as a drawback. Incidental operations on the merchandise, such as testing, cleaning, repacking, or inspection, are not considered “uses” of the article. To obtain a drawback, the U.S. firm must file a proposal with a regional commissioner of customs or with the Entry Rulings Branch of the CBP.

U.S. Foreign Trade Zones

To encourage and facilitate international trade, countries all over the world have established **export-processing zones (EPZs)** including free trade zones, special economic zones, bonded warehouses, free ports, and customs zones. EPZs have evolved from initial assembly and simple processing activities to encompass high-tech and science parks, finance zones, logistics centers, and even tourist resorts. They now include not only general-type zones but also single-industry zones and single-commodity zones. There are more than 600 EPZs in more than 100 countries. Many U.S. manufacturers and their distributors use these zones for receiving shipments of goods that are reshipped in smaller lots to customers throughout the surrounding areas.

In some circumstances no duties may be owed, or the duties payable may be deferred to some future time. For instance, goods placed in a government **bonded warehouse** or entered into a **free trade zone (FTZ)** are not subject to duties until officially entered into the country. An importer may use a free trade zone to assemble or manufacture a product from imported components in order to take advantage of duty preferences. To encourage

and facilitate international trade, more than 300 free ports, FTZs, and similar customs-privileged facilities are now in operation in some 75 foreign countries, usually in or near seaports or airports. Federal regulations define a FTZ as a “restricted-access area, in or adjacent to a Customs port of entry.” The importer pays customs on the lower amount between goods value when imported as parts into the FTZ and the value after assembly or manufacture in the FTZ.

For export operations, the zones provide accelerated export status for purposes of excise tax rebates. Duties are not collected when the goods are in the FTZ. For import and reexport activities, no customs duties, federal excise taxes, or state or local *ad valorem* taxes are charged on foreign goods moved into FTZs unless the goods or products are officially imported into the U.S. FTZs are especially useful for assembling products. There are more than 200 approved FTZs in communities throughout the U.S. These facilities are available for storage, repacking, inspection, exhibition, assembly, manufacturing, and other processing.

Customs-Bonded Warehouses

Bonded warehouses are found in many locations. A customs-bonded warehouse is a building or other secured area in which dutiable goods may be stored or undergo manufacturing operations, without payment of duty. A bonded warehouse is more limited in scope than the FTZ. An importer may store finished products in a bonded warehouse for a period of time if the importer expects duty rates to decrease, but manufacturing is not permitted unless the goods are subsequently exported. When goods enter a bonded warehouse, both the importer and the warehouse proprietor incur financial and legal liability under a bond. No duty is collected until merchandise is withdrawn. If no domestic buyer is found for the imported articles, the importing company can sell merchandise for exportation, without paying duties. Items subject to quota or other restrictions may be stored in a bonded warehouse until the restrictions are repealed.

Section 337 of Tariff Act of 1930

This long-standing law, found in many countries, allows the ITC to take action against “unfair practices” related to the importation of goods into the U.S. The two types of harms that Section 337 seeks to prevent are infringement on American intellectual property rights and harm to an American industry. First, it targets imported goods that infringe on American copyrights, patents, and trademarks. Second, the ITC may take action if the unfair trade practices affect or threaten to substantially harm an American industry or restrain or monopolize American commerce. If the ITC finds any of the above violations it may exclude the goods from entering the country. It may also issue a cease and desist order targeted at future violations and levy civil penalties (fines). The Federal Trade Commission (FTC) also has the power to seize and destroy the goods.

Anti-Dumping Provisions of the Tariff Act of 1930

As discussed previously in Chapter 5 at pages 161–62 (“Anti-Dumping”), Section 731 of the Tariff Act allows for the assessment of countervailing duties (tariffs) against imported goods that are being imported at a price below the cost of production or at a subsidized price (illegal support of foreign government reducing the costs of the goods). In determining if the goods being imported are in violation of anti-dumping (selling price at below fair value) and illegal subsidies, the U.S. government compares the import price with the “normal value” of the goods. A number of methods are used to determine if the import price is below normal value: (1) import price is below what is charged in the country of export; (2) price charged for the goods when exported to other countries; and (3) imported goods are priced below the cost of production. If it is determined that the goods are being sold at below normal value (dumping) or have benefited by illegal foreign subsidies, then the U.S. government can charge countervailing duties to offset the below market price of the goods. See Figure 6.5 *Doing Business Internationally*: “Summary of U.S. Trade Remedies” for a brief review of the response to the dumping and illegal subsidization of imported goods.

The International Trade Administration (ITA) of the Department of Commerce (DOC) enforces laws and agreements in order to protect U.S. businesses from unfair competition resulting from unfair pricing (dumping) by foreign companies and the giving of unfair subsidies to foreign companies by their governments.

What is Dumping?

Dumping occurs when a foreign producer sells a product in the United States at a price that is below that producer's sales price in the country of origin (home market), or at a price that is lower than the cost of production. The difference between the price (or cost) in the foreign market and the price in the U.S. market is called the dumping margin.

What is a Countervailable Subsidy?

Foreign governments subsidize industries when they provide financial assistance (cash payments, credits against taxes, and loans at terms that do not reflect market conditions) to benefit the production, manufacture, or exportation of goods. The amount of subsidies from the government is the basis for the subsidy rate by

which the subsidy is offset, or countervailed, through higher import duties.

How is Dumping or Subsidization Remedied?

A U.S. industry that believes it is being injured by the dumping of imported goods, or the giving of illegal foreign subsidies of imported products, may request the imposition of anti-dumping or countervailing duties by filing a petition with the ITA. To ensure that there is sufficient support by domestic industry for the investigation, the law requires that the petitioners must represent at least 25 percent of domestic production. The International Trade Commission (ITC) determines whether the domestic industry is suffering material injury as a result of the imports of the dumped or subsidized products.

If both DOC and the ITC make affirmative findings of dumping and injury, DOC instructs the CBP (Customs and Border Protection) to assess duties against imports of the products. The duties are assessed as a percentage of the value of the imports and are equivalent to the dumping and subsidy margins, described above in order to offset the amount of the dumping or subsidy.

Figure 6.5 *Doing Business Internationally*: Summary of U.S. Trade Remedies.

Country of Origin

The modern trend is to use resources in a number of locations in the manufacture of goods. The global marketplace includes the global manufacture of goods. Globalization presents problems in determining the country of origin for a good that is a product of processes that take place in different countries. Recognizing that there is a lack of international uniformity for country of origin criteria, the Uruguay Round of GATT adopted the **Agreement on Customs Valuation**. Although it is currently only a framework agreement, it establishes fair valuation as an internationally recognizable principle. It further makes transaction value the internationally preferred means of calculating dutiable value.

The country of origin of a good is used to determine the applicable tariff rate and whether any quantitative restrictions are relevant. For example, a product of a less developed country is often given a reduced tariff rate under the GSP. Also, lower tariffs and restrictions are available for goods produced within a free trade area. Thus, the NAFTA provides a unique set of country of origin rules to determine if a good is to be considered a regional or NAFTA product.

Country-specific or industry-specific restrictions like anti-dumping duties, quotas, and voluntary restraint agreements are dependent upon the determination of the country of origin. Unfortunately, country of origin determinations can be complicated and uncertain for a number of reasons. First, country of origin rules generally come from national import laws; individual countries have used different criteria and have varied in their interpretations. Second, the rise of the global marketplace for goods, services, and raw materials, along with the development of global corporations, has resulted in products being manufactured in different stages in different countries with component parts coming from all over the world. Thus, the true country of origin is often difficult to determine.

Country of origin rules are also used to conform to import laws pertaining to the labeling of products manufactured, produced, assembled, or made from materials from different countries. A number of methods have been developed to make this determination. **Substantial transformation** is considered the primary test in country of origin determinations and is the one adopted under U.S. law. Under this approach, the country of origin is the last country in which a good or product was substantially transformed. A substantial transformation occurs when a

product is changed into a new or different product. For example, if a good has changed from a producer good to a consumer good, a substantial transformation has occurred.

The Supreme Court in *Anheuser-Busch v. United States*⁴ defined a substantial transformation as one where a good is “manufactured into a new and different article, having a distinctive name, character, or use from that of the original article.” Factors often utilized in applying this test include whether the good went through a tariff classification change, the amount of value added because of the transformation, and the complexity of the processing operation. For example, the greater the value added the more likely that a substantial transformation has occurred.

An alternative method to determine country of origin is to perform a value-added analysis. The **value-added test** is based upon the use of percentages, either of the value added or percentage of component parts coming from imported materials, to determine the country of origin. Used in the EU, this method was adopted under NAFTA for goods transported from one NAFTA country to another. NAFTA’s country of origin rules apply the value-added test as part of a multistep approach depending on the type of product being imported. In general, non-regional (non-NAFTA) materials or components need to be sufficiently transformed in order to result in a tariff classification change.

In some areas, not only do non-regional goods have to be substantially transformed, but the final end product needs to contain a specified percentage of regional (NAFTA) content (value-added). The value-added percentage applied under NAFTA varies according to the type of good. Automobiles, for example, are required to have a regional content equal to 62.5 percent or more of NAFTA-originating materials and labor.

A number of problems are associated with the value-added method. First, it penalizes lesser-developed countries because of their low costs of labor and raw materials. Second, multinational enterprises may manipulate transfer pricing among their affiliated companies to reduce the value of imported materials in order to avoid tariff duties or to ensure a certain country of origin designation.

Transfer Pricing is the setting of the price for goods and services sold between controlled or related legal entities within an enterprise. In principle, a transfer price should match either what the seller would charge an independent arm’s length customer or would pay an arm’s length supplier. Companies often misuse transfer pricing to lower profits in a division of an enterprise that is located in a country that levies high taxes and to raise profits in a country that has low taxes. Transfer pricing is a major illegal tool for corporate tax avoidance.

The **specified processes test** expressly lists the types of processes or operations that are considered to confer country of origin status. However, this test has not been used comprehensively. Instead, it has been used in a piecemeal fashion to target certain products. For example, EU Commission Regulation 288/99 grants origin status to an integrated circuit wherever it undergoes diffusion. An example of a negative version of the test is EU Regulation 2071/89, which holds that the location of the assembly of an optical system does not provide a presumption that that location is the country of origin for imported photocopiers.

The final method of origin determination is the **change in tariff classification** approach. This test bases country of origin status upon any change in a product that results in a change in its tariff classification. Tariff classifications are almost universally affixed using the Harmonized Commodity Description and Coding System. This classification system has been enacted in the United States in the HTS. The most recent attempt at harmonizing country of origin rules is the **Origin Agreement** of GATT. The Origin Agreement adopts the change in tariff classification as the primary method to determine origin.

In conjunction with the Origin Agreement, the **Technical Committee on Rules of Origin** and the Committee on Rules of Origin have been established to interpret the rules. The Origin Agreement also emphasizes the importance of transparency. It requires all WTO countries to publish their nation’s origin rules and applications of their rules. It also requires members to give a binding assessment to anyone who requests an advanced

determination of origin. The binding assessment must then be honored for a period of three years for all comparable goods or imports.

The CBP administers a number of laws that revolve around the country of origin of imported goods. These laws include those relating to marking requirements, qualification for trade preferences under a free trade agreement, application of anti-dumping duties and quota restrictions, and granting of a special duty status for tariff reductions. The country of origin determinations may vary under the different statutes. Therefore, it is possible for the same good to be considered originally from Country A for purposes of marking and from Country B for purposes of assessing a duty. The next section explores the application of country of origin rules to national marking requirements.

Country of Origin Marking Requirements

The CBP is in charge of enforcing the law on the marking of imported goods. The U.S. **marking requirements** are found in Section 304(a) of the Tariff Act of 1930. It states that “every article of foreign origin imported into the United States shall be marked in a conspicuous place in such manner as to indicate to an ultimate purchaser the English name of the country of origin.”⁵ The country of origin is where the item or product was manufactured, produced, or grown. The purpose of these requirements is to inform the **ultimate purchaser** of the country in which the imported article was made. The ultimate purchaser is the last person in the country of import who receives the article in the form in which it was imported. If the imported good is an input and goes through a “substantial transformation” due to manufacturing or processing, then it becomes a good from the country in which it was transformed. A substantial transformation occurs if a new article with a different name, character, and use is created. Figure 6.6 provides some of the technical aspects to the marking of goods. The Tariff Act provides severe punishment including fines and imprisonment for anyone destroying, removing, or altering any mark required under the Act. In addition, anyone importing unmarked items is subject to civil penalties including an additional 10 percent *ad valorem* duty.

Countries’ requirements for packaging and labeling products vary from country to country. The box shows the basic requirements for Canada.

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| <ul style="list-style-type: none"> • <i>Legibility:</i> The marking must be legible. This means it must be of an adequate size, and clear enough, to be read easily by a person of normal vision. • <i>Conspicuousness:</i> The marking should be located in a conspicuous place. It must be where it can be seen with a casual handling of the article. Markings cannot be covered or concealed by subsequent attachments or additions. • <i>Permanency:</i> The article should be marked as indelibly and permanently as the nature of the product will permit so that it remains until the article reaches the ultimate purchaser. • <i>Abbreviations and Spellings:</i> Abbreviations that unmistakably indicate the name of a country (Luxemb for Luxembourg) and variant spellings (Italie for Italy) are acceptable. However, E.U. is not an acceptable abbreviation since it does not indicate an individual country of origin. • <i>Forms of Marking:</i> The best form of marking are ones that become a part of the article, such as branding, stenciling, stamping, printing, and molding. | <ul style="list-style-type: none"> • <i>Special Marking Requirements:</i> There are also product-specific marking requirements. For example, Chapter 91 of the U.S. HTS sets forth special marking requirements for watches and clocks. Under normal marking requirements, the watch’s country of origin must appear conspicuously and legibly on the dial face. In addition, watches must be marked on one of the bridges or top plates with the name of the country of manufacture, name of the manufacturer, and the number of jewels, if any, serving a mechanical purpose as frictional bearings. Watch cases shall be marked on the inside or outside of the back to show the name of the country of manufacture, and the name of the manufacturer or purchaser. The watches and cases must be conspicuously and indelibly marked by cutting, die sinking, engraving, stamping, or mold-marking. Note the special marking requirements do not apply to watches with optoelectronic display. • <i>No Marking Required:</i> Articles produced more than 20 years prior to their importation need not specify country of origin. |
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Figure 6.6 Technical Requirements of Marking.

CBP’s “Marking of Country of Origin” (January 2015).

Canada's Consumer Packaging and Labelling ActThree Mandatory Statements on Labels

Product Identity Declaration (Product's generic name or function)

Product Net Quantity (Metric system)

Dealer's Name and Place of Business

Other Requirements

Statements must be written in English and French

Quebec Law: English text cannot be larger than French text

The labeling standards remain important even after the goods are imported into a country. For example, Nestlé India had to destroy \$50 million of Maggi noodle as a result of improper labeling. The Indian food authorities claimed the noodle contained unsafe levels of lead and the packages were mislabeled. Tests indicated that the noodles contained the chemical flavor enhancer monosodium glutamate (MSG) and that it was not stated on the product's list of ingredients.

Markings and Free Trade Agreements

FTAs often include marking requirements relating to trading within the free trade area. For example, the United States, Canada, and Mexico are members of NAFTA, which offers lower tariffs for items produced in those three countries. Canada, for example, wants to ensure that items coming from the U.S. were actually produced there and not simply shipped there from a non-NAFTA country to be forwarded to Canada. There is a specific NAFTA Certificate of Origin for items produced in those three countries. See Chapter 7 for more information on FTAs.

NAFTA provides a formula to determine whether a good was produced in a NAFTA country, in order to take advantage of the lower tariff rates between the United States, Canada, and Mexico. The labeling of a product regarding its country of origin may mean different things depending upon the law or test being applied. The use of the label "Made in the USA" may vary depending on the appropriate regulations. NAFTA defines something made in a NAFTA country, whether in the United States, Canada, or Mexico, as something in which at least 55 percent of the labor and component parts were supplied by a NAFTA country. In contrast, the U.S. Department of Transportation requires that a motor vehicle must be 75 percent the product of the United States before it may be considered "Made in the USA." The Federal Trade Commission states that the "Made in the USA" label should be used in advertising only when "all, or virtually all, of the components and labor are of U.S. origin."

Customs Modernization Act

Under the **Customs Modernization Act**, the legal responsibility for classifying and valuing imported products was transferred from the CBP to the importer of the goods. The importer is under a duty of *reasonable care* to correctly classify and value the goods being imported. This duty cannot legally be delegated to a customs broker. The importer remains liable for any misclassification or undervaluation.

The importer's secondary responsibility under the Modernization Act is to implement a proper record-keeping system. Failure to maintain adequate records that substantiate the importer's customs declarations can result in substantial penalties. Because of this shifting of responsibility to the importer, goods now enter the U.S. more quickly without the need for CBP inspections. Instead, the CBP will rely on the examination of documents and post-entry audits.

National Import Restrictions, Requirements, and Standards

The GATT was successful in drastically lowering worldwide tariffs and in broadening the world trade system through the adoption of a package of agreements known as the 1994 WTO Agreements (WTO Agreements). The main existing barriers to trade are those involving Technical Barriers to Trade (TBT) and national health and safety standards.

Standards Requirements

The existence of non-harmonized standards for similar products or technologies in different countries or regions can contribute to so-called “technical barriers to trade.” Standards are technical specifications or other precise criteria to be used as rules, guidelines, or definitions of characteristics, to ensure that materials, products, processes, and services are fit for their intended purposes. All countries have enacted requirements that certain goods or services meet their country’s standards before being allowed entry. These country-specific standards are not always transparent and in the past may have acted as barriers to trade.

In more recent times, there have been regional efforts to harmonize product standards. In the EU, standards harmonization has allowed for the free movement of goods within the Union. Most recently, voluntary standards have been developed that allow a company to affix an **ecolabel** to its products. An ecolabel is a voluntary mark awarded by the EU to producers who can show that their products are significantly less harmful to the environment than similar products. A more recent development is the EU’s **CE mark**. This “umbrella” label warrants that the good bearing the mark meets all relevant EU Directives relating to that type of product.

Internationally, the 1994 WTO Agreements include a framework for the harmonization of some health and safety standards. The two framework agreements are the WTO Agreement on Technical Barriers to Trade (TBT) and the WTO Agreement on the Application of Sanitary and Phytosanitary Measures (SPS). The further development of international standards will contribute to making life simpler and to increasing the reliability and effectiveness of the goods and services we use.

In the area of service standards, GATS requires that all countries review their laws so that “qualification requirements and procedures, technical standards, and licensing requirements do not constitute unnecessary barriers to trade in services.” Any such requirements should be “based on objective and transparent criteria.” In the area of professional services, each country “shall provide for adequate procedures to verify the competence of professionals” of any other country.

Historically, the International Labour Organization (ILO) has been active in developing international labor standards. The ILO was established in 1919 and became a specialized agency of the United Nations in 1946. It seeks to promote social justice in areas such as employment, pay, health, working conditions, and freedom of association among workers. Its headquarters is in Geneva, Switzerland.

Forced or Indentured Labor Product Information

Section 307 of the Tariff Act of 1930 prohibits the importation of merchandise mined, produced, or manufactured, wholly or in part, in any foreign country by forced labor including prison labor and forced child labor. Such merchandise is subject to exclusion or seizure and may lead to a criminal investigation of the importer.

Export Regulations

The **Export Administration Regulations (EAR)** provide a general overview of U.S. export restrictions as published by the **Bureau of Export Administration (BXA)**. The BXA is organized into two branches: Export Administration and Export Enforcement. Export Administration implements and administers the export controls as detailed in the EAR. It consists of five offices: Office of Nuclear and Missile Technology Controls, Office of Chemical and Biological Controls and Treaty Compliance, Office of Strategic Trade and Foreign Policy Controls,

Office of Strategic Industries and Economic Security, and Office of Export Services. The last office provides assistance to exporters and reexporters, conducts educational seminars, and maintains the EAR. The Export Enforcement branch has three offices: Office of Export Enforcement, Office of Environmental Support, and Office of Antiboycott Compliance. The last office enforces the Restrictive Trade Practices and Boycotts restrictions enacted under U.S. law.

Section 2403 of the EAR explains the types of licenses available for exporting goods: (1) validated license, authorizing a specific export; (2) validated license authorizing multiple exports including the distribution license, project license, service supply license, and the comprehensive operations license; and (3) general license, authorizing exports, without application by the exporter. Validated licenses, including those for specific exports along with those for multiple exports, require written approval from the Department of Commerce. The general license requires only the submission of the **Shipper's Export Declaration (SED)**. The term *general license* is a misnomer because it does not result in a license being issued by the government. The **general license** is a grant of authority to all exporters and is sufficient for most of the goods exported from the U.S. No application for exportation or government approval is needed when exporting under a general license, just a filing of a SED.

If a validated license is not required, then the goods may be exported under a general license without any specific application. In the past, the CBP required the filing of a paper SED. The SED, now known as Electronic Export Information (EEI), is a U.S. Government process for collecting export trade statistics and for export enforcement. The information is filed through the **Automated Export System (AES)**, and all filings must be made electronically.

Exporters are also required to place a **Destination Control Statement** on commercial invoices and bills of lading for most export sales. These statements alert foreign buyers of goods and documents that diversion contrary to U.S. law is prohibited. The Destination Control Statement requires that the following language be placed upon all export documents including the bill of lading and commercial invoice: "These commodities, technology, or software were exported from the United States in accordance with the Export Administration Regulations. Diversion contrary to U.S. law is prohibited."

In some instances, exporters must obtain a **validated license** for certain products and for export to certain countries. A validated license grants authority to a specific exporter to export specific products. Whether a validated license is required will be determined through a review of a number of regulations: First, whether the country of import is on the **Country Group List**. Second, whether the product being exported is on the **Commodity Control List**. Third, whether any "special restrictions" apply to the export. The Country Group List consists of countries that are being boycotted by the U.S. government. The Commodity Control List is a list of sensitive products whose export is restricted or regulated.

If a validated license is required, the exporter must submit an "Application for a Validated Export License." In order to expedite the application process the exporter should obtain an "International Import Certificate" or a **Statement by Ultimate Consignee and Purchaser** (Figure 6.7). The former is issued by the government of importation and certifies that the goods will be disposed of in the designated country. The Statement by Ultimate Consignee and Purchaser is an assurance from the purchaser that the goods will not be resold or disposed of contrary to the requirements of the export license.

A freight forwarder or customs broker may assist the exporter in preparing documentation, including the Statement by Ultimate Consignee and Purchaser form. However, it is important to know that the exporter is ultimately responsible for the accuracy of all the export documents. A clause should state the country of importation and prohibit the purchaser-importer from selling, delivering, or reexporting the goods to another country or any country prohibited under U.S. law. For more information on exporting from the U.S., see Figure 6.8 *Focus on Transactions*: "Helpful Hints for Exporters."

Exportation of certain specific goods may also require approval from a number of other government agencies. Table 6.3 provides a list of some of the agencies and programs that must approve the export of "sensitive" products.

The EAR covers more than exports. It also covers reexports of some foreign products such as those products produced abroad under U.S. licenses, activities of U.S. citizens anywhere in the world involving

FORM BIS-711 FORM APPROVED UNDER OMB CONTROL NO. 0694-0021, 0694-0093	U.S. DEPARTMENT OF COMMERCE BUREAU OF INDUSTRY AND SECURITY <small>Information furnished herewith is subject to the provisions of Section 12(c) of the Export Administration Act of 1979, as amended, 50 U.S.C. app 2411(c) and its unauthorized disclosure is prohibited by law.</small>	DATE RECEIVED (Leave Blank)
STATEMENT BY ULTIMATE CONSIGNEE AND PURCHASER		
1. ULTIMATE CONSIGNEE	CITY	
ADDRESS LINE 1	COUNTRY	
ADDRESS LINE 2	POSTAL CODE	TELEPHONE OR FAX
2. DISPOSITION OR USE OF ITEMS BY ULTIMATE CONSIGNEE NAMED IN BLOCK 1 We certify that the items: <i>(left mouse click in the appropriate box below)</i>		
<p>A. <input type="checkbox"/> Will be used by us (as capital equipment) in the form in which received in a manufacturing process in the country named in Block 1 and will not be reexported or incorporated into an end product.</p> <p>B. <input type="checkbox"/> Will be processed or incorporated by us into the following product (s) _____ to be manufactured in the country named in Block 1 for distribution in _____</p> <p>C. <input type="checkbox"/> Will be resold by us in the form in which received in the country named in Block 1 for use or consumption therein. The specific end-use by my customer will be _____</p> <p>D. <input type="checkbox"/> Will be reexported by us in the form in which received to _____</p> <p>E. <input type="checkbox"/> Other (describe fully) _____</p> <p><small>NOTE: If BOX (D) is checked, acceptance of this form by the Bureau of Industry and Security as a supporting document for license applications shall not be construed as an authorization to reexport the items to which the form applies unless specific approval has been obtained from the Bureau of Industry and Security for such export.</small></p>		
3. NATURE OF BUSINESS OF ULTIMATE CONSIGNEE NAMED IN BLOCK 1 A. The nature of our usual business is _____ B. Our business relationship with the U.S. exporter is _____ and we have had this business relationship for _____ year(s).		
4. ADDITIONAL INFORMATION		
5. ASSISTANCE IN PREPARING STATEMENT		
STATEMENT OF ULTIMATE CONSIGNEE AND PURCHASER <small>We certify that all of the facts contained in this statement are true and correct to the best of our knowledge and we do not know of any additional facts which are inconsistent with the above statement. We shall promptly send a supplemental statement to the U.S. Exporter, disclosing any change of facts or intentions set forth in this statement which occurs after the statement has been prepared and forwarded, except as specifically authorized by the U.S. Export Administration Regulations (15 CFR parts 730-774), or by prior written approval of the Bureau of Industry and Security, we will not reexport, resell, or otherwise dispose of any items approved on a license supported by this statement (1) to any country not approved for export as brought to our attention by means of a bill of lading, commercial invoice, or any other means, or(2) to any person if we know that it will result directly or indirectly, in disposition of the items contrary to the representations made in this statement or contrary to Export Administration Regulations.</small>		
6. SIGNATURE OF OFFICIAL OF ULTIMATE CONSIGNEE	7. NAME OF PURCHASER	
NAME OF OFFICIAL	SIGNATURE OF PURCHASER	
TITLE OF OFFICIAL	NAME OF OFFICIAL	
DATE (mmm,dd,yyyy)	TITLE OF OFFICIAL	
CERTIFICATION FOR USE OF U.S. EXPORTER - We certify that no corrections, additions, or alterations were made on this form by us after the form was signed by the (ultimate consignee)(purchaser).	DATE (mmm,dd,yyyy)	
8. NAME OF EXPORTER	SIGNATURE OF PERSON AUTHORIZED TO CERTIFY FOR EXPORTER	
NAME OF PERSON SIGNING THIS DOCUMENT	TITLE OF PERSON SIGNING THIS DOCUMENT	DATE (mmm,dd,yyyy)
We acknowledge that the making of any false statements or concealment of any material fact in connection with this statement may result in imprisonment or fine, or both and denial, in whole or in part, of participation in U.S. exports and reexports.		
<small>Public reporting burden for this collection of information is estimated to average 15 minutes per response plus one minute for recordkeeping, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to the Director of Administration, Room 3889, Bureau of Industry and Security, U.S. Department of Commerce,</small>		
<small>Washington, DC 20230, and to the Office of Management and Budget Paperwork Reduction Project (0694-0021, 0694-0093), Washington, D.C. 20503. Notwithstanding any other provision of law, no person is obligated to respond to nor shall a person be subject to a penalty for failure to comply with a collection of information subject to the Paperwork Reduction Act unless that collection of information displays a currently valid OMB Control Number.</small>		

Figure 6.7 Statement by Ultimate Consignee and Purchaser.

- 1 Determine if a validated export license is required. When in doubt, contact the Exporters Service Staff Office of Export Administration.
- 2 Fully describe commodities or technical data on export shipping documents.
- 3 Use the applicable destination control statement on commercial invoices, airway bills, and bills of lading.
- 4 Avoid shipments after the expiration date on the validated export license.
- 5 Enter the applicable validated export license number or general license symbol on the Shipper's Export Declaration.
- 6 Make certain the export documents clearly identify the exporter, intermediate consignee, and ultimate consignee.
- 7 Stay current with export control requirements by subscribing annually to the Export Administration Regulations.
- 8 Avoid inadvertent sales to persons or firms denied U.S. export privileges by obtaining a copy of the Table of Denial Orders Currently in Effect, available from the Office of Export Administration.
- 9 Designate an appropriate person to monitor export transactions to ensure compliance with the Regulations. Enroll appropriate personnel in the Office of Export Administration's export licensing training program.

Figure 6.8 Focus on Transactions: Helpful Hints for Exporters.

(Office of Export Enforcement).

Table 6.3 Export Control Regulations: (Export Control Classification Number or ECCN).

Program	Overseeing Agency	Scope	Exporter Responsibility
Export Administration Regulations (EAR)	Dept. of Commerce Bureau of Industry and Security	Dual-use products Export of goods which may compromise national security	Check denied parties lists Determine ECCN (if needed) Apply for license (if needed)
International Traffic in Arms Regulations (ITAR)	Bureau of Industry and Security Dept. of State U.S. Military	Control the sale of items used for military purposes	Check if products are on U.S. Munitions List (USML) Determine if a license is needed for your product Contact U.S. Commercial Service
Office of Foreign Assets Control (OFAC)	Dept. of the Treasury	Economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign countries and regimes, terrorists, international narcotics traffickers, entities engaged in activities related to the proliferation of weapons of mass destruction, and other threats to U.S. national security, foreign policy, or economy	OFAC is not a regulator, and therefore cannot require your bank to establish any internal compliance procedures However, all U.S. persons must comply with OFAC regulations OFAC encourages all exporters to maintain a rigorous risk-based compliance program
Nuclear Regulatory Agency	Dept. of Energy	Nuclear propulsion equipment	Licensing required for nuclear non-proliferation, chemical, or biological equipment

technical assistance with respect to encryption commodities or software, and certain transactions within the U.S. The last category includes the release of technology to a foreign national in the U.S. It also includes the return of foreign equipment to its country of origin after repair in the U.S., shipments from U.S. FTZs, and the electronic transmission of nonpublic data. The severity of punishment for failing to obtain the appropriate export license is demonstrated in the hypothetical case of *United States v. Shetterly*.

United States v. Donald Shetterly

971 F.2d 67 (7th Cir. 1992)

Kanne, Circuit Judge. After a jury trial, Donald Shetterly was convicted of attempting to export a controlled microwave amplifier to Belarus without an export license in violation of § 2410(a) of the Export Administration Act (EAA), and was sentenced to 41 months imprisonment. He now appeals his conviction and sentence.

Mr. Shetterly was introduced to Karl Mann, a Belarusian businessman. Mr. Shetterly sent electronic equipment, including microwave amplifiers and computer software, to Mr. Mann in Belarus. Mann sent a letter to Shetterly requesting him to purchase an amplifier from Berkshire Technologies, Inc., a California company. Berkshire informed Shetterly that the amplifier was on the Department of Commerce's Commodity Control List and required a validated license to export the amplifier out of the U.S. Export licenses are required for exporting certain commodities under the EAA. A general license merely requires that the commodity meets certain standards—no license application is necessary and no license document is issued.

One of the goals of the EAA is to protect national security. A validated license requires the exporter to file a license application before exporting commodities that cannot be exported under a general license. Such commodities are included in the Department of Commerce's Commodity Control List. This case arose prior to the breakup of the former Soviet Union. In line with cold war attitudes, Mr. Lum of Berkshire testified that he was suspicious that the destination of the amplifier was overseas because other countries wanted to obtain the amplifier. Mr. Shetterly argues that the technology involved was already available abroad.

Section 2410(a) states that anyone who "knowingly violates or conspires to or attempts to violate any provision of the EAA" commits a crime. Mr. Shetterly contends that

an exportation or attempted exportation of a controlled commodity without a license becomes a crime only if the exporter knows that a license is required. We agree with the government's assertions that specific intent is not required. The government was only required to prove beyond a reasonable doubt that Mr. Shetterly knowingly exported or attempted to export a controlled commodity, without obtaining the appropriate export license.

Finally, Mr. Shetterly argues that the district court misapplied the Sentencing Guidelines. However, the 41-month sentence is the minimum in cases where "national security or nuclear proliferation controls were involved." Mr. Shetterly also alleges the district court erred in failing to consider the degree to which the violation threatened a U.S. security interest, the volume of commerce involved, the extent of planning or sophistication, and whether there were multiple occurrences in determining a sentence under the Sentencing Guidelines. Even though the district judge indicated that he considered that it would no longer be illegal to export the Berkshire amplifier out of the country without a license, we have no jurisdiction to review his refusal to depart from the Sentencing Guidelines. **AFFIRMED.**

Case Highlights

- Export licenses are required for exporting certain commodities under the Export Administration Act.
- A general license requires merely that the commodity meets certain standards—no license application is necessary and no license document is issued.
- A good that is on the Department of Commerce's Commodity Control List requires a validated license.
- Knowingly exporting or attempting to export a controlled commodity without a license is a crime.

Also of concern for exporters of hazardous materials is the Basel Convention. Adopted in 1989 by a United Nations-sponsored conference of 116 nations in Basel, Switzerland, this Convention restricts trade in hazardous waste. An exporter of such materials should review the Convention to determine the requirements for export clearance through the CBP.

Dual-Use Products

Items with both commercial and military or nuclear proliferation applications are known as "dual-use products" and must be licensed by the DOC's Bureau of Industry and Security (BIS).

Bureau of Industry and Security (BIS) administers and enforces the Export Administration Regulations (EAR), which regulate the export and reexport of commercial commodities and technology.

The regulations governing these types of products are found in the EAR. Before shipping a product, an exporter should understand both the concept of dual use and basic export-control regulations. Relatively few items require a dual-use export license, but such licenses are required in certain situations involving national security, short supply, nuclear and missile technology, crime control, or concerns about terrorism. An item's technical characteristics, its destination, its end-use and end-user, and other activities of the end-user determine whether a license is required.

Opening Access to Foreign Markets

Section 301 of the Trade Act of 1974 is unique in that it focuses on opening foreign markets to U.S. exports and investment. It allows the U.S. to take *unilateral action* against a foreign country denying open access to American companies. The WTO Agreements provide a process that allows countries to impose countervailing duties against goods being dumped, illegally subsidized, or that threaten a domestic industry. However, there is no such process in the case of market access for exported goods. In 1999, the World Trade Commission ruled that Section 301 did not violate the WTO Agreements as long as the U.S. waited to impose unilateral sanctions until after the WTO ruled whether the alleged improper practice was within the scope or jurisdiction of the WTO.

Special 301 was enacted in 1988 and gives greater power to the USTR to open foreign markets. It allows the USTR to create "priority watch lists" to designate countries that should be monitored for unfair trade practices. In 1991, the USTR named the first three countries to the priority list—China, India, and Thailand. Ever since, China has been the target of numerous Special 301 investigations. The result has been angry disputes and threats of a trade war. Every time, however, the U.S. and China reached compromises before any Section 301 sanctions were levied by the USTR. For example, in response to U.S. charges of Chinese infringing on American intellectual property rights (see Chapter 18), China agreed to become a member of the Berne Convention on Trademarks and Patents. See Chapter 9, "Emerging Economies: China," for further information on combatting the piracy and counterfeiting of American intellectual property rights in China.

Chapter Summary

- 1 The free trade area beginning with the latter Rounds of GATT and the creation of the WTO has made exporting and importing goods much easier as massive amounts of goods move around the world. However, the harmonization of trade law created by the WTO is far from complete. Therefore, national import and export controls remain, and exporter-importers need to be informed on the specifics of each nation's trade regulations where they do business.
- 2 Three basic types of laws regulate the importation of goods: (1) assessment of duties, (2) marking requirements, and (3) standards requirements.
- 3 The harmonized tariff schedule (HTS), published by the World Customs Organization, provides the product descriptions and accompanying tariff rates that are used by most trading countries.
- 4 Tariff rates below those offered under the WTO are available through free trade areas, such as NAFTA, and through the generalized system of preferences (GSP), which is targeted to helping less developed countries.
- 5 Importers to the U.S. are responsible for determining the proper classification in the HTS that best describes the good being imported.
- 6 The import duties owed by the importer are determined using three valuables: (1) classification of the goods (HTS), (2) the country of origin, and (3) the value of the goods. The first two variables are used to determine the tariff rate, which is then applied against the value of the goods to determine the amount of the duty.

- 7 Drawback is a form of tax relief in which a lawfully collected customs duty is refunded or remitted wholly or in part because of the particular use made of the commodity on which the duty was collected.
- 8 Tariff duties and fees may be voided, at least temporarily, by the use of free trade zones and bonded warehouses.
- 9 Determining and verifying country of origin is an important part of the importation process, as well as satisfying highly technical “marking” requirements.
- 10 The U.S. Tariff Act provides the government the means to protect domestic companies including: (1) Section 1337, which aims to prevent the importation of goods that infringe on American intellectual property rights; (2) Section 731, which allows the assessment of countervailing duties against goods being dumped (below normal value) on the U.S. market and goods that have been illegally subsidized by foreign governments.
- 11 Export Administration Regulations (EAR) authorizes the granting of general and validated export licenses.
- 12 Under U.S. export law, most goods can be freely exported out of the country without government approval by simply filing a Shipper’s Export Declaration.
- 13 Exporters must obtain a validated license for certain products and for export to certain countries. The products and countries that require the U.S. exporter to obtain a validated license are found on the Commodity Control List and the Country Group List.
- 14 Section 301 of the Trade Act and Special 301 enable U.S. government agencies to unilaterally retaliate against foreign countries that do not allow open access to American goods.

Key Terms

<i>Ad Valorem</i> Duties	Ecolabel	Shipper’s Export Declaration
Agreement on Customs	Essential Character	(SED)
Valuation	Export Administration	Special 301
Automated Export System (AES)	Regulations (EAR)	Specific Duties
Bonded Warehouse	Export-Processing	Specified Processes Test
Bureau of Export Administration	Zones (EPZ)	Statement by Ultimate
(BXA)	Foreign Affairs Doctrine	Consignee and Purchaser
CE Mark	Free Trade Zone (FTZ)	Substantial Transformation Test
Change in Tariff Classification	General License	TARIC
Test	Generalized System of	Technical Committee on Rules of
Commodity Control List	Preferences (GSP)	Origin
Computed Value	Harmonized Tariff Schedule	Trade and Tariff Act of 1984
Country Group List	(HTS)	Transaction Value
Country of Origin	Immigration and Customs	Transfer Pricing
Customs Modernization Act	Enforcement	Ultimate Purchaser
Deductive Value	<i>Maquiladora</i>	Validated License
Destination Control	Marking Requirement	Value-Added Test
Statement	Origin Agreement	World Customs Organization
Drawback	Rule of Specificity	(WCO)

Chapter Problems

- 1 The CBP classified aluminum ingots that were shipped to the United States from Canada as not of Canadian origin. The ingots contained less than 1 percent materials from countries other than Canada. The CBP imposed a tariff of 0.19 percent on aluminum ingots imported from Canada.

- The Court of International Trade ruled in favor of the CBP, finding that the aluminum underwent “substantial transformation” because a foreign-origin substance (grain refiner) was mixed with the aluminum to make the ingots less likely to crack and therefore worked a substantial transformation. Alcan protested that the tariff should be the 0.038 percent that would apply under NAFTA if the ingots had not undergone “substantial transformation” with goods that originated from outside of Canada. Do you think that the Court’s decision was correct? *Alcan Aluminum Corp. v. U.S.*, 165 F.3d 898 (Fed. Cir. 1999).
- 2 William C. Dart sought to overturn a decision by the Secretary of Commerce imposing civil sanctions for violations of the Export Administration Act. The Export Act precludes judicial review of such fines under its so-called “finality clause.” What are the competing concerns of the person fined and the limited appeal procedure provided in the Export Act? Has the world changed in a way that has changed the balance between these concerns? *Dart v. United States*, 848 F.2d 217 (D.C. Cir. 1988).
 - 3 Import documentation requirements and other regulations imposed by foreign governments vary from country to country. It is vital that exporters be aware of the regulations that apply to their own operations and transactions. Many governments, for instance, require consular invoices, certificates of inspection, health certification, and various other documents. Select a country and research its basic documentary requirements for the importation of goods.

Internet Exercises

- 1 Visit the web site of the United States Customs and Border Control (CBP) at <http://www.cbp.gov/trade/automated/getting-started> in order to learn about its electronic filing system.
- 2 You are an importer of outboard motorboats from South Korea. Search the harmonized tariff schedule (HTS) at <https://hts.usitc.gov> to determine the duty rate you will be required to pay.
- 3 Research the customs law of Japan and compare them to those of the United States. To compare the customs law of another country, see the web site for Japanese Customs at http://www.mof.go.jp/english/customs_tariff/index.html.
- 4 You have completed an export contract and need to ship goods from Miami, Florida to Buenos Aires, Argentina. Determine which shipping lines are available for such a shipment and research the documentation needed for such a shipment. See the following web sites: <http://www.mgn.com/> (“Maritime Global Net”) and <http://www.tradeport.org>. (TradePort is a comprehensive site on international shipping and trade.)
- 5 How does the new United States Automated Export System work? See U.S. Customs and Border Protection website at <http://www.cbp.gov/>.

Other Internet Sources

U.S. Harmonized Tariff Schedule: <http://www.usitc.gov>.

World Customs Organization: <http://www.wcoomd.org>.

NAFTA Customs: <http://www.cbp.gov/trade/nafta/a-guide-to-customs-procedures> (rules of origin and valuation matters).

U.S. Automated Export System: <http://www.cbp.gov/trade/aes>.

EU Ecolabel: <http://ec.europa.eu/environment/ecolabel/>.

CE Mark: <http://www.cemarking.net>.

U.S. Customs and Border Protection (CBP): <http://www.cbp.gov>.

Notes

1 19 U.S.C.A. § 1401a (b)(1)(B). See *Monarch Luggage Co. v. U.S.*, 715 F. Supp. 1115 (1989).

2 19 U.S.C.A. § 1401a (b)(1)(D).

3 19 U.S.C.A. §§ 1401a (b)(1)(C) 7 1401a (h)(1). See *Texas Apparel Co. v. U.S.*, 698 F. Supp 932 (Ct. of Int'l Trade 1988).

4 207 U.S. 556 (1908).

5 19 U.S.C. § 1304(a).

FREE TRADE AGREEMENTS

This chapter will review four types of methods or agreements used to increase the free flow of goods, services, and investments between countries. These trade and investment enhancing agreements are reviewed in order of their bindingness and scope: (1) **free trade agreements (FTAs)**, (2) **bilateral investment treaties (BITs)**, (3) **Cooperation Agreements**, and (4) **free or foreign trade zones (FTZs)**. First, FTAs, after the World Trade Organization's (WTO's) Agreements and WTO trading system (see Chapter 5 on "International Trade Regulation"), are the most important means of facilitating international trade. While the WTO is worldwide in scope, FTAs entail a smaller group of countries. An FTA is an agreement between two or more countries where the countries agree on certain obligations that affect trade in goods and services, and protections for investors and intellectual property rights, among other topics.

The FTA creates competitive advantages (lower tariffs, removal of quantitative restrictions) among the countries of the FTA that are not extended to countries outside of the FTA. This would normally violate the WTO's most-favored-nation and national treatment principles, which require one WTO member country to treat all other WTO countries in the same manner. For example, if a country reduces a tariff rate for certain goods coming from one WTO country, it has to provide that same rate to all other WTO members. However, Article XXIV of the WTO Agreement provides an exception to FTAs that meet certain requirements. Article XXIV states:

The contracting parties of the WTO recognize the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries party to such agreements. They also recognize that the purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories.

WTO and FTAs: Technically, FTAs violate the rules of the WTO in that they allow certain countries to offer lower tariff rates to each other without offering the same rates to all other WTO members. This violates a core principle of the WTO—the "most-favored-nation" principle that mandates the lower tariff rates between two WTO countries must be provided to all other WTO members. The most-favored-nation principle has been a major force in lowering worldwide tariff rates over the last half-century. The WTO Agreement provides exceptions for establishing a free trade area (NAFTA) or an external common customs union (European Union), under Article XXIV of the General Agreement on Tariffs and Trade (GATT) and Article V of the General Agreement on Trade in Services (GATS).

In essence, Article XXIV treats the FTA as a singular country: "Each such customs territory shall, exclusively for the purposes of the territorial application of the WTO Agreement, be treated as though it were a contracting party." By being recognized as a single entity for WTO purposes, FTAs cannot be accused of violating the most-favored-nation or national treatment principles.

FTAs are not as comprehensive as the WTO Agreements. However, the new generation of FTAs have expanded their scope, beyond trade in goods and services, and the protection of foreign investment. FTAs entered into by the U.S. include provisions on environmental protection, labor and employment rights, and the protection of intellectual property rights.

The trend over the past few decades has seen a proliferation in FTAs. The U.S. has entered into numerous FTAs in recent years; the most important of which is the 1994 **North American Free Trade Agreement (NAFTA)** with Canada and Mexico. This chapter will focus its attention on NAFTA but will also review the **Central America–Dominican Republic FTA (CAFTA-DR)** and the **Korea–U.S. Free Trade Agreement (KORUS FTA)**. Also, the U.S. has concluded a “mega” FTA with Pacific Rim countries, known as the Trans-Pacific Partnership (TPP) (subject to Congressional approval), and is negotiating another one with the European Union, known as the **Transatlantic Trade and Investment Partnership (T-TIP)**, which will be discussed later in this chapter.

Second, BITs have been a longstanding method whereby two countries provide assurances to one another’s citizens, companies, and investors doing business in each other’s country. This chapter uses the **Estonia–U.S. Bilateral Investment Treaty** as an example of the common provisions found in BITs. BITs consist of legally binding obligations, with a pre-agreed dispute resolution process in the event a country breaches its obligations.

Third, Cooperation Agreements are opening statements of cooperation between two countries that do not have a tradition of trade between them. These agreements are more preliminary and less detailed in nature than BITs. They are preliminary in nature as nontraditional trading partners seek to establish the basis for freer trade and cooperation that hopefully will lead to a broader and more binding BIT. This chapter will review the **Belarus–EU Partnership and Cooperation Agreement**.

Fourth, FTZs will be examined as an important tool of international trade. FTZs provide the advantages of entering within an area of the country of import without formally passing through customs. This allows for the delay in paying tariffs until the goods are formally passed through customs. The goods or materials may be processed or assembled within the FTZ and then either imported into the country or exported out of the FTZ to another country. The FTZ provides high security warehouses where goods may be safely stored or processed.

Benefits of Free Trade Agreements

The objectives of FTAs include the expansion and diversification of trade; elimination of barriers to trade in goods and services, to increase investment opportunities; and to advance effective environmental protection, labor rights, and the enforcement of intellectual property rights. These objectives are accomplished through the implementation of the core principles of national treatment, most-favored-nation treatment, and transparency within the FTA.

Why should exporters or importers care about FTAs? An American company looking to export its products or services should check to see if the U.S. has negotiated favorable treatment for its citizens and companies through an FTA. Accessing FTA benefits for your product may require more record keeping, but it can also give your product a competitive advantage versus products from other countries. Figure 7.1, “Case Study: Designing Export Systems for the Complexity of International Trade,” shows how one company innovatively transformed its internal control systems to make their goods ready for exporting, including taking advantage of preferential tariff rates provided by NAFTA and to conform to NAFTA’s Rules of Origin.

For the U.S., the main goal of trade agreements is to reduce barriers to U.S. exports, protect U.S. interests competing abroad, and enhance the rule of law in the FTA partner country or countries. The primary benefit of FTAs is to lower tariff and other barriers to trade between the countries that are members of an FTA, including tariff rates below those offered by membership in the WTO. The ultimate goal of FTAs is the movement of goods across national borders tariff-free. The reduction of trade barriers and the creation of a more stable and transparent trading and investment environment make it easier and cheaper for U.S. companies to export their products and services to markets of foreign country partners.

Six years ago, Outdoors Pro, Inc. (Outdoors) hired Susan Gogetter to develop and direct its export-compliance program. The company—one of America’s premier outdoor sports retailers, with retail stores across America and Canada—wanted to ensure that international sales from its web site were fully compliant with U.S. export regulations.

Business Challenge

Outdoors needed to ensure that its operations were as streamlined and efficient as possible. The company has over 90,000 SKUs and fills 800 to 1,200 international orders per week, so the export-compliance process needed to be as automated as possible.

What is an SKU? A stock-keeping unit (SKU) is a unique number that is used to identify a billable item in a company’s inventory. When a stock-keeping unit is assigned, the number reflects the smallest possible unit that a store will stock. In a warehouse, this is typically a box that contains multiples of the same items.

Approach

First, Gogetter’s team developed an internal IT program capable of storing the regulatory information about the company’s products and added fields for Export Control Classification Numbers (ECCNs), HTS numbers (harmonized tariff schedule; see Chapter 6 on “National Import and Export Regulation”), country of origin, and NAFTA eligibility, so it could collect the required export information directly from its suppliers. (ECCNs are special numbers used for export licensing purposes.) Each one of Outdoors’ suppliers is required to provide harmonized tariff code numbers and country-of-origin information when Outdoors places an order. The information provided by less experienced vendors is reviewed to ensure its accuracy.

The company ensures that its products comply with export regulations by stipulating that an item cannot be exported until it has been assigned a HTS code number, an approved ECCN, and a

corresponding country of origin, and that an export-compliance associate has approved this information.

If any of that information is missing, the order generates an error code and the products are ineligible for export until the requisite information has been entered or corrected. Also, Outdoors’ export-system software compares each product’s ECCN to the destination’s country code to determine whether the articles can be shipped to the destination country without an export license. (Export licenses are discussed in Chapter 6 on “National Import and Export Regulation.”) If all the information is present and correct, then the company’s automated export system approves the articles for inclusion in an export order.

Outdoors also developed a system to annually renew its country of origin certifications for all products eligible for export (certifications are usually valid for 12 months). This allows them to take advantage of preferential tariff rates stipulated in trade agreements like NAFTA. This annual renewal process requires Outdoors to send a communication to suppliers to certify the country of origin of all products they supply.

Insights

Every company should train a compliance associate, who will attend training on Export Administration Regulations (EAR) and other export controls. If your company sells products or technology that fall under International Traffic in Arms Regulations (ITAR), your compliance associate should receive ITAR training.

Outdoors and the U.S. Commercial Service

Outdoors uses this information to state the appropriate country of origin on the requisite export documentation. A physical Certificate of Origin is not included in shipments, but only when the customer asks for the certificate, or if the item gets held up in customs. For shipments to NAFTA countries, low-value shipments (shipments valued at \$1,000 or less) don’t require a Certificate of Origin in order to receive preferential tariff treatment. Outdoors’ computer system tracks SKUs that are eligible for preferential treatment under NAFTA—a statement is added to the bottom of the commercial invoice noting that NAFTA treatment applies.

Figure 7.1 Case Study: Designing Export Systems for the Complexity of International Trade.

How can FTAs benefit U.S. exporters or investors? U.S. FTAs typically address a wide variety of government activities. One example is the reduction or elimination of tariffs charged on **regional or qualified goods** coming from the other country. For example, a country that normally charges a tariff of 6 percent of the value of the incoming product will eliminate that tariff for products that originate in another FTA member country. Documenting how a product originates, or meets the rules of origin, can make using the FTA negotiated tariffs more complicated. However, these rules help to ensure that U.S. exports, rather than exports from other countries, receive the benefits of the agreement.

Regional or Qualified Goods: To benefit from the lower tariff rates of NAFTA, goods must come from a NAFTA country and/or be “NAFTA goods.” If Mexico imports goods from a non-NAFTA country and reexports them to the U.S., those goods would not be NAFTA (regional goods) and would not benefit from NAFTA tariff rates. A regional good is one that is: (1) wholly obtained or produced in NAFTA territory, (2) produced with materials originating in NAFTA

territories, or (3) made from NAFTA originating materials and non-NAFTA materials and that has been substantially transformed in a NAFTA country and/or have 50–60 percent of regional content or value depending on the goods and methods of determining value.

Some other types of opportunities frequently found in FTAs include: (1) the ability for a U.S. company to bid on government procurements (goods and services) contracts in an FTA partner country; (2) the ability for a U.S. investor to get prompt, adequate, and effective compensation if its investment in the FTA partner country is expropriated (taken) by the government; (3) the ability for U.S. service suppliers to supply their services in FTA partner countries; (4) protection and enforcement of American-owned intellectual property rights; and (5) the ability for U.S. exporters to participate in the development of product standards in FTA partner countries.

U.S. Free Trade Agreements

The U.S. currently has 14 FTAs in force with 20 countries: Australia, Bahrain, Chile, Colombia, CAFTA-DR (Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua), Israel, Jordan, South Korea, Morocco, NAFTA (Canada and Mexico), Oman, Panama, Peru, and Singapore. As noted earlier, the U.S. has reached agreement on a major regional FTA, the Trans-Pacific Partnership (TPP), with Australia, Brunei, Canada, Chile, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam, and is negotiating another one with the European Union, known as the Transatlantic Trade and Investment Partnership (T-TIP).

North American Free Trade Agreement (NAFTA)

The NAFTA is a regional agreement between Canada, Mexico, and the U.S. Although controversial during its negotiation and enactment, NAFTA has proved beneficial to all three countries in creating a truly “North American marketplace.” U.S. exports to Canada and Mexico support more than three million American jobs, and U.S. trade with its NAFTA partners has unlocked opportunities for millions of Americans by supporting Made-in-America jobs and exports. Canada and Mexico are America’s two largest export markets; they buy more American goods and services than any other country in the world. See Image 7.1: “Combined Flags of the NAFTA Countries.”

Article 102 of NAFTA states that: The objectives of this Agreement, as elaborated more specifically through its principles and rules, including national treatment, most-favored-nation treatment, and transparency, are to: (1) eliminate barriers to trade in, and facilitate the cross-border movement of goods and services between the territories of the Parties; (2) promote conditions of fair competition in the FTA; (3) increase investment opportunities in the territories of the Parties; (4) provide adequate and effective protection and enforcement of intellectual property rights in each Party’s territory; (5) create effective procedures for the implementation and application of the Agreement, for its joint administration, and for the resolution of disputes; and (6) establish a framework for further trilateral, regional, and multilateral cooperation to expand and enhance the benefits of the Agreement.

As noted previously, FTAs have to fit within the WTO system. Article 103 of NAFTA deals with the issue of its “Relation to Other Agreements.” It states that the countries of NAFTA affirm their existing rights and obligations with respect to each other under the *General Agreement on Tariffs and Trade*. If there is a conflict between NAFTA and international agreements, which agreement controls? The answer is that it depends on what “other agreement” NAFTA is in conflict. First, it cannot conflict with the WTO Agreements. Second, NAFTA controls over previous agreements between the NAFTA countries. Third, NAFTA provides ordering rules pertaining to NAFTA’s relationship with certain other agreements. In general, it states that NAFTA shall prevail to the extent of the inconsistency. However, Article 104, entitled “Relation to Environmental and Conservation Agreements,” gives preferences to the specific trade regulations of the following agreements

When Did the NAFTA enter into force? The North American Free Trade Agreement (NAFTA) between Canada, the United States, and Mexico entered into force on January 1, 1994.

What is the NAFTA Secretariat? The NAFTA Secretariat is an independent agency that is responsible for the impartial administration of the dispute resolution provisions of NAFTA. It has Canadian, Mexican, and American Sections, each headed by a national Secretary, with offices in each of the national capitals. The Secretariat is accountable to the NAFTA Free Trade Commission, which comprises the ministers responsible for international trade in the three NAFTA countries, such as the U.S. International Trade Representative.

How long does the NAFTA dispute settlement process take? Under Article 1904 on Binational Panel Reviews, the rules are designed to result in decisions within 315 days after the

commencement of the panel review. Extraordinary Challenge Committee proceedings result in decisions of committees within 105 days after the commencement of the proceeding.

What are NAFTA's general legal principles (*principes juridiques généraux*) (*principios generales de derecho*) **that relate to the settlement of disputes?** The principles include standing (a party having an economic interest recognized by NAFTA), due process (reasonable notice and a fair hearing), common rules of statutory construction (reasonable interpretation of the provisions of NAFTA), mootness (harm no longer exists or dispute settled in another legal venue), and exhaustion of administrative remedies (parties have participated in all administrative processes required prior to the filing of the complaint).

National Sections of the Secretariat are maintained in Ottawa, Mexico City, and Washington, D.C.

Figure 7.2 NAFTA Facts.

when in conflict with NAFTA: (1) *Convention on International Trade in Endangered Species* (1979), (2) *Montreal Protocol on Substances that Deplete the Ozone Layer* (1990), and (3) the *Basel Convention on the Control of Transboundary Movements of Hazardous Wastes* (1989). Again, such obligations prevail to the extent of inconsistency, provided that where a Party has a choice among equally effective and reasonably available means of complying with such obligations, the Party chooses the alternative that is the least inconsistent with the provisions of NAFTA.

In order to obtain the benefits of the preferential tariff rates of NAFTA, the key concept is the goods must come from an originating state and the goods must qualify under the rules of origin. Each FTA has its own **Rules of Origin (ROO)** that describe how exported goods shipped to a country or a region may qualify for duty-free or reduced-duty benefits. In determining the country of origin, a number of tests or rules apply including substantial transformation, product-specific, and percentage-based formulas. FTAs contain specific chapters on Rules of Origin Procedures and lists all product-specific ROO by harmonized tariff schedule (HTS) numbers.

On the tariff side, NAFTA has had an immediate impact on reducing barriers, especially on manufactured goods. The complete elimination of tariffs is likely to harm some domestic industries in the short term, so NAFTA contains **snapback provisions** that allow for the reinstitution of previous tariff levels at times in order to alleviate short-term negative impacts on domestic industries and businesses.

NAFTA enacted a series of complicated rules of origin that the North American businessperson must master in order to earn the lower NAFTA tariff rates. Goods must be certified as **regional goods** in order to cross NAFTA borders freely, which means the goods originated in a NAFTA country or passed the test of **substantial transformation** (where a good or material is further processed), which usually results in a *tariff classification change* for the goods.

However, for some goods, such as certain textile products, the materials used to produce the goods must go through a **triple transformation** in order to obtain regional-goods status. Other products, like automobiles, electronics, and machinery, have to pass stringent *cost tests*. Depending on the type of good, somewhere between 50 percent and 62.5 percent of the good's costs must be regional in origin. In sum, ROO may require: (1) a change in tariff classification, (2) a regional value-content requirement, or (3) both a change in tariff classification and a regional value-content requirement. Each product type will have specific ROO, which may be determined through the product's HTS classification. See Chapter 6 for coverage of the HTS.

In order to export to another NAFTA country and obtain preferential tariff treatment under NAFTA, the exporter needs to complete and provide the importer a NAFTA Certificate of Origin. The Certificate may also be completed by the producer of the goods for the use of the exporter. See Figure 7.3: "NAFTA Certificate of Origin."



Image 7.1 Combined Flags of the NAFTA Countries.

Source: Nicoguardo, Wikimedia Commons.

The importer must present the Certificate to the import or customs authority at the time of importation. The Certificate states:

THE GOODS ORIGINATED IN THE TERRITORY OF ONE OR MORE OF THE PARTIES, AND COMPLY WITH THE ORIGIN REQUIREMENTS SPECIFIED FOR THOSE GOODS IN THE NORTH AMERICAN FREE TRADE AGREEMENT. THERE HAS BEEN NO FURTHER PRODUCTION OR ANY OTHER OPERATION OUTSIDE THE TERRITORIES OF THE PARTIES.

The criteria for determining entitlement for the lower NAFTA tariffs based on the ROO and as declared in the Certificate of Origin are as follows:

- The good is “wholly obtained or produced entirely” in the territory of one or more of the NAFTA countries. Note: The purchase of a good in the territory does not necessarily render it “wholly obtained or produced.”
- The good is produced entirely in the territory, but not all of the materials used originated in a NAFTA country, but the good goes through a tariff classification change (due to its production or manufacture in the NAFTA country) or satisfies the regional value-content requirement or a combination of both.
- The good is an originating agricultural good and is not subject to a quantitative restriction in the importing NAFTA country because it is a “qualifying good.”

The breadth of NAFTA and its potential impact on regional trade can be seen in the Table 7.1, which lists some of the committees and groups authorized by NAFTA articles. The standing committees and working groups’ goals are

U.S. Customs and Border Protection
**NORTH AMERICAN FREE TRADE AGREEMENT
CERTIFICATE OF ORIGIN**

19 CFR 181.11, 181.22

1. EXPORTER NAME, ADDRESS AND EMAIL	2. BLANKET PERIOD FROM (mm/dd/yyyy) TO (mm/dd/yyyy)
TAX IDENTIFICATION NUMBER: 3. PRODUCER NAME, ADDRESS AND EMAIL	4. IMPORTER NAME, ADDRESS AND EMAIL TAX IDENTIFICATION NUMBER:

5. DESCRIPTION OF GOOD(S)	6. HS TARIFF CLASSIFICATION NUMBER	7. PREFERENCE CRITERION	8. PRODUCER	9. NET COST	10. COUNTRY OF ORIGIN

- I CERTIFY THAT:
- THE INFORMATION ON THIS DOCUMENT IS TRUE AND ACCURATE AND I ASSUME THE RESPONSIBILITY FOR PROVING SUCH REPRESENTATIONS. I UNDERSTAND THAT I AM LIABLE FOR ANY FALSE STATEMENTS OR MATERIAL OMISSIONS MADE ON OR IN CONNECTION WITH THIS DOCUMENT;
 - I AGREE TO MAINTAIN AND PRESENT UPON REQUEST, DOCUMENTATION NECESSARY TO SUPPORT THIS CERTIFICATE, AND TO INFORM, IN WRITING, ALL PERSONS TO WHOM THE CERTIFICATE WAS GIVEN OF ANY CHANGES THAT COULD AFFECT THE ACCURACY OR VALIDITY OF THIS CERTIFICATE;
 - THE GOODS ORIGINATED IN THE TERRITORY OF ONE OR MORE OF THE PARTIES, AND COMPLY WITH THE ORIGIN REQUIREMENTS SPECIFIED FOR THOSE GOODS IN THE NORTH AMERICAN FREE TRADE AGREEMENT AND UNLESS SPECIFICALLY EXEMPTED IN ARTICLE 411 OR ANNEX 401, THERE HAS BEEN NO FURTHER PRODUCTION OR ANY OTHER OPERATION OUTSIDE THE TERRITORIES OF THE PARTIES; AND
 - THIS CERTIFICATE CONSISTS OF PAGES, INCLUDING ALL ATTACHMENTS.

11.	11a. AUTHORIZED SIGNATURE	11b. COMPANY
	11c. NAME	11d. TITLE
	11e. DATE (mm/dd/yyyy)	11f. TELEPHONE NUMBERS <div style="display: flex; justify-content: space-between;">(Voice)(Facsimile)</div>
		11g. EMAIL

estimated average time to complete this application is 15 minutes. If you have any comments regarding the burden estimate you can write to U.S. Customs and Border Protection, Office of Regulations and Rulings, 90 K Street, NE., Washington DC 20229.

NORTH AMERICAN FREE TRADE AGREEMENT CERTIFICATE OF ORIGIN INSTRUCTIONS

For purposes of obtaining preferential tariff treatment, this document must be completed legibly and in full by the exporter and be in the possession of the importer at the time the declaration is made. This document may also be completed voluntarily by the producer for use by the exporter. Please print or type:

- FIELD 1: State the full legal name, address (including country), email and legal tax identification number of the exporter. Legal taxation number is: in Canada, employer number or importer/exporter number assigned by Revenue Canada; in Mexico, federal taxpayer's registry number (RFC); and in the United States, employer's identification number or Social Security Number.
- FIELD 2: Complete field if the Certificate covers multiple shipments of identical goods as described in Field #5 that are imported into a NAFTA country for a specified period of up to one year (the blanket period). "FROM" is the date upon which Certificate becomes applicable to the good covered by the blanket Certificate (it may be prior to the date of signing this Certificate). "TO" is the date upon which the blanket period expires. The importation of a good for which preferential treatment is claimed based on this Certificate must occur between these dates.
- FIELD 3: State the full legal name, address (including country), email and legal tax identification number, as defined in Field #1, of the producer. If more than one producer's good is included on the Certificate, attach a list of additional producers, including the legal name, address (including country) and legal tax identification number, cross-referenced to the good described in Field #5. If you wish this information to be confidential, it is acceptable to state "Available to CBP upon request". If the producer and the exporter are the same, complete field with "SAME". If the producer is unknown, it is acceptable to state "UNKNOWN".
- FIELD 4: State the full legal name, address (including country), email and legal tax identification number, as defined in Field #1, of the importer. If the importer is not known, state "UNKNOWN"; if multiple importers, state "VARIOUS".
- FIELD 5: Provide a full description of each good. The description should be sufficient to relate it to the invoice description and to the Harmonized System (H.S.) description of the good. If the Certificate covers a single shipment of a good, include the invoice number as shown on the commercial invoice. If not known, indicate another unique reference number, such as the shipping order number.
- FIELD 6: For each good described in Field #5, identify the H.S. tariff classification to six digits. If the good is subject to a specific rule of origin in Annex 401 that requires eight digits, identify to eight digits, using the H.S. tariff classification of the country into whose territory the good is imported.
- FIELD 7: For each good described in Field #5, state which criterion (A through F) is applicable. The rules of origin are contained in Chapter Four and Annex 401. Additional rules are described in Annex 703.2 (certain agricultural goods), Annex 300-B, Appendix 6 (certain textile goods) and Annex 308.1 (certain automatic data processing goods and their parts). **NOTE: In order to be entitled to preferential tariff treatment, each good must meet at least one of the criteria below.**

Preference Criteria

- A The good is "wholly obtained or produced entirely" in the territory of one or more of the NAFTA countries as referenced in Article 415. **Note: The purchase of a good in the territory does not necessarily render it "wholly obtained or produced"**. If the good is an agricultural good, see also criterion F and Annex 703.2. (*Reference: Article 401(a) and 415*)
- B The good is produced entirely in the territory of one or more of the NAFTA countries and satisfies the specific rule of origin, set out in Annex 401, that applies to its tariff classification. The rule may include a tariff classification change, regional value-content requirement, or a combination thereof. The good must also satisfy all other applicable requirements of Chapter Four. If the good is an agricultural good, see also criterion F and Annex 703.2. (*Reference: Article 401(b)*)
- C The good is produced entirely in the territory of one or more of the NAFTA countries exclusively from originating materials. Under this criterion, one or more of the materials may not fall within the definition of "wholly produced or obtained", as set out in article 415. All materials used in the production of the good must qualify as "originating" by meeting the rules of Article 401(a) through (d). If the good is an agricultural good, see also criterion F and Annex 703.2. (*Reference: Article 401(c)*).
- D Goods are produced in the territory of one or more of the NAFTA countries but do not meet the applicable rule of origin, set out in Annex 401, because certain non-originating materials do not undergo the required change in tariff classification. The goods do nonetheless meet the regional value-content requirement specified in Article 401(d). This criterion is limited to the following two circumstances:
1. The good was imported into the territory of a NAFTA country in an unassembled or disassembled form but was classified as an assembled good, pursuant to H.S. General Rule of Interpretation 2(a), or
 2. The good incorporated one or more non-originating materials, provided for as parts under the H.S., which could not undergo a change in tariff classification because the heading provided for both the good and its parts and was not further subdivided into subheadings, or the subheading provided for both the good and its parts and was not further subdivided.
- NOTE: This criterion does not apply to Chapters 61 through 63 of H.S. (Reference: Article 401(d))**
- E Certain automatic data processing goods and their parts, specified in Annex 308.1, that do not originate in the territory are considered originating upon importation into the territory of a NAFTA country from the territory of another NAFTA country when the most-favored-nation tariff rate of the good conforms to the rate established in Annex 308.1 and is common to all NAFTA countries. (*Reference: Annex 308.1*)
- F The good is an originating agricultural good under preference criterion A, B, or C above and is not subject to a quantitative restriction in the importing NAFTA country because it is a "qualifying good" as defined in Annex 703.2, Section A or B (please specify). A good listed in Appendix 703.2B.7 is also exempt from quantitative restrictions and is eligible for NAFTA preferential tariff treatment if it meets the definition of "qualifying good" in Section A of Annex 703.2. **NOTE 1: This criterion does not apply to goods that wholly originate in Canada or the United States and are imported into either country. NOTE 2: A tariff rate quota is not a quantitative restriction.**
- FIELD 8: For each good described in Field #5, state "YES" if you are the producer of the good. If you are not the producer of the good, state "NO" followed by (1), (2), or (3), depending on whether this certificate was based upon: (1) your knowledge of whether the good qualifies as an originating good; (2) your reliance on the producer's written representation (other than a Certificate of Origin) that the good qualifies as an originating good; or (3) a completed and signed Certificate for the good, voluntarily provided to the exporter by the producer.
- FIELD 9: For each good described in field #5, where the good is subject to a regional value content (RVC) requirement, indicate "NC" if the RVC is calculated according to the net cost method; otherwise, indicate "NO". If the RVC is calculated over a period of time, further identify the beginning and ending dates (MM/DD/YYYY) of that period. (*Reference: Article 402.1, 402.5*).
- FIELD 10: Identify the name of the country ("MX" or "US" for agricultural and textile goods exported to Canada; "US" or "CA" for all goods exported to Mexico; or "CA" or "MX" for all goods exported to the United States) to which the preferential rate of CBP duty applies, as set out in Annex 302.2, in accordance with the Marking Rules or in each party's schedule of tariff elimination.
- For all other originating goods exported to Canada, indicate appropriately "MX" or "US" if the goods originate in that NAFTA country, within the meaning of the NAFTA Rules of Origin Regulations, and any subsequent processing in the other NAFTA country does not increase the transaction value of the goods by more than seven percent; otherwise indicate "JNT" for joint production. (*Reference: Annex 302.2*)
- FIELD 11: This field must be completed, signed, and dated by the exporter. When the Certificate is completed by the producer for use by the exporter, it must be completed, signed, and dated by the producer. The date must be the date the Certificate was completed and signed.

Figure 7.3 NAFTA Certificate of Origin.

Table 7.1 NAFTA Committees and Groups

NAFTA Standing Committees	Small Business
Trade in Goods	Working Groups
Sanitary and Phytosanitary Measures	Working Group on Customs
Land Transportation Standards	Working Group on Agricultural Subsidies
Financial Services	Working Group on Trade and Competition
Private Commercial Disputes	Working Group on Rules of Origin
Telecommunications Standards	

to produce harmonization or mutual recognition of national rules and standards. The businessperson operating within NAFTA countries should closely monitor such efforts.

NAFTA was the result of years of contentious in negotiation, approval, and implementation. The *Made in the USA Foundation* case, which involved a constitutional challenge to the NAFTA agreement, serves to illustrate the comparative powers of the U.S. President and Congress in the area of international trade agreements.

NAFTA's ultimate long-term impact on trade is likely to come in its nontariff provisions, which include an agreement to reduce barriers to foreign direct investment, to eliminate performance standards, to ensure the free flow of capital, to offer expropriation assurances, and to institute a dispute resolution mechanism.

NAFTA Protection of Foreign Investment

Chapter 11 of NAFTA establishes a mechanism for the settlement of investment disputes that assures both parties equal treatment in accordance with the principles of international reciprocity and due process before an impartial tribunal. An investor under NAFTA who alleges that a host government has breached its investment obligations may bring an arbitration claim to the World Bank's International Centre for Settlement of Investment Disputes (ICSID) or under the United Nations Commission on International Trade Law Arbitration Rules (UNCITRAL Rules). Alternatively, the investor may choose the remedies available in the host country's domestic courts.

Made in the USA Foundation v. United States of America

56 F. Supp. 2d 1226 (N.D.C. Alabama 1999)

Propst, District Judge. In 1990 the United States, Mexico, and Canada initiated negotiations with the intention of creating a "free trade zone" through the elimination or reduction of tariffs and other barriers to trade. After two years of negotiations, the leaders of the three countries signed the North American Free Trade Agreement (NAFTA or Agreement) on December 17, 1992. Congress approved and implemented NAFTA on December 8, 1993, with the passage of the NAFTA Implementation Act (Implementation Act).

The President purportedly negotiated and concluded NAFTA pursuant to his constitutional responsibility for conducting the foreign affairs of the United States and in accordance with the Omnibus Trade and Competitiveness Act of 1988 under the so-called "fast-track" procedure. Congress then approved and implemented NAFTA by enacting the Implementation Act, pursuant to its power to legislate in the areas of tariffs and domestic and foreign

commerce. The plaintiffs contend that the failure to go through the Treaty Clause in Article II, Section 2 of the U.S. Constitution renders the Agreement and, apparently, the Implementation Act, unconstitutional.

"Fast-Track" legislation or what is known as "fast track negotiating authority": fast track negotiating authority is a temporary and controversial power granted to the President by Congress. It is not a permanent authority but lasts for limited periods of time related to the negotiation of specific trade agreements. The most recent fast track authority was granted by Congress to negotiate major trade agreements with Asia (TPP) and Europe (T-TIP). Congress can approve or disapprove any future agreements but cannot amend or filibuster the agreement.

The issues are the following:

- 1 Does NAFTA constitute a “treaty” as contemplated by Article II, Section 2 of the Constitution?
- 2 Even if NAFTA constitutes a “treaty” as contemplated by Article II, Section 2 of the Constitution, was the making and implementation of NAFTA authorized under other provisions of the Constitution?

Remarkably, in the over 200 years of this nation, the U.S. Supreme Court has not specifically and definitively decided the principles applicable to these issues.

Constitutionality of NAFTA

The Treaty Clause states that the President “shall have the Power, by and with the Advice and Consent of the Senate, to make Treaties, provided two-thirds of the Senators present concur.” The plaintiffs’ ultimate argument in this case is that the Treaty Clause should be read as an exclusive grant of power with respect to those international agreements that may be called “treaties,” and that NAFTA falls within the bounds of the proper definition of the term. The plaintiffs acknowledge that the text of the Constitution fails to establish a test for determining when an international agreement is a “treaty” as opposed to some other type of agreement.

It is also clear that under international law the Agreement would be considered to be a treaty, and there is no clear distinction between what constitutes a treaty under international law as opposed to a treaty “in the constitutional sense.” While NAFTA is likely a treaty, it may not be a “treaty,” as contemplated by the Treaty Clause.

Nevertheless, I will assume that it is such. The most significant issue before the court is whether the Treaty Clause is an exclusive means of making an international agreement under the circumstances of this case.

The fact that the President has the power to make treaties by and with the advice and consent of the Senate is not saying that agreements with foreign nations cannot otherwise be made and implemented. However, it should be noted that the Supreme Court has upheld the power of Congress to delegate to the President the ability to negotiate and conclude agreements with foreign nations or to implicitly approve the President’s actions with respect to such agreements. Under such circumstances, the President is said to “exercise not only his powers but also those delegated by Congress,” and has been allowed to conclude international agreements settling claims of United States citizens. I hold that the President had the authority to negotiate and conclude NAFTA pursuant to his executive authority and pursuant to the authority granted to him by Congress in accordance with the terms of the Omnibus Trade and Competitiveness Act of 1988.

Case Highlights

- The Treaty Clause of the U.S. Constitution grants the President the power to make treaties by and with the advice and consent of the Senate.
- NAFTA is considered a treaty according to international law.
- Congress may also delegate additional powers to negotiate international agreements to the President, as it did under its “fast-track” legislation.

Anti-dumping and Countervailing Duty Determinations

As with the WTO Agreements in the exporting and importing of goods, the two major areas of disputes under NAFTA involve the dumping of goods and **illegal government subsidies**, which allow domestic manufacturers and growers to export and sell their goods at below market prices. Dumping is the sale of goods in foreign markets at prices below those charged for *comparable sales* in the home market or that are *below the cost of production*. As discussed previously, **anti-dumping duties** are special levies or tariffs imposed on imported merchandise to protect an affected domestic industry from injury caused by the sale of dumped goods. Generally, illegal subsidies occur when imported goods benefit from foreign government financial assistance. Examples of subsidies include: loans at preferential rates, grants, tax incentives, or the providing of goods or services by a government at prices below market levels. A **countervailing duty (CVD)** is a special duty imposed on imported merchandise to protect a domestic industry from injury caused by illegally subsidized imports being sold at below market prices. An injury is caused by dumped or subsidized imports resulting in lost sales, reduced prices, lost market share, decreased profits, and other such difficulties for the injured industry.

NAFTA establishes a mechanism—independent **binational review panels**—to provide an alternative to judicial review by domestic courts of “final determinations” (rulings) in the areas of anti-dumping duties and

countervailing duties. In all three NAFTA countries, there are two agencies that serve different functions relative to NAFTA. One agency conducts investigations to determine whether a domestic industry has suffered injury due to the dumping of goods. Another agency is empowered to convene binational review panels for parties that would like to appeal a government's anti-dumping determination and assessment of anti-dumping or countervailing duties.

A Panel is established when a Request for Panel Review is filed with the **NAFTA Secretariat** by an industry asking for a review of an investigating authority's decision involving imports from a NAFTA country. In Canada, the request for a review would be filed with the Canada Border Services Agency (CBSA), which makes dumping and subsidy determinations, while the Canadian International Trade Tribunal (CITT) conducts inquiries into whether or not the dumping or subsidy has caused injury or retardation or is threatening to cause injury to a domestic industry. In the U.S., it is the Department of Commerce, **International Trade Administration**, which makes dumping and subsidy determinations, while the United States **International Trade Commission** conducts injury inquiries. In Mexico, it is the *Secretaría de Economía, Unidad de Prácticas Comerciales Internacionales* that makes both the dumping/subsidy and injury determinations. These agencies are referred to as investigating authorities. The dumping, subsidy, and injury determinations of the investigating authorities can also be appealed, in Canada to the Federal Court of Canada, in the U.S. to the **Court of International Trade**, and in Mexico to the *Tribunal Fiscal de la Federación*.

The two Binational Panel Decisions that follow focus on the two key elements needed to sustain a case of dumping: (1) differential between the "normal value" of goods and the dumping price and (2) material injury requirement (the dumping of goods is causing or threatens harm to a domestic industry of the country of import). *National Gypsum* reviews issues that relate to the first element. The case was brought under the Canada–United States Free Trade Agreement, which preceded NAFTA. In that case, the American exporter of gypsum board was accused of dumping goods onto the Canadian market. A key fact is that over a three-year period, the American share of the Canadian gypsum market doubled in size.

Another case dealt with the issue of the harm caused to a country's domestic industry due to the illegal dumping of imported goods. The *Hot-Rolled Carbon Steel* case deals with the requirement of showing "injury to a domestic industry" in the case of illegal dumping.

NAFTA Dispute Resolution Process

Individual companies or industries may file written complaints requesting an investigation of imports for violations of NAFTA dumping and subsidies provisions. The **Investigating Authority** means the competent authority in each nation that issues final determinations relating to anti-dumping and countervailing duties. As noted above, a "competent investigating authority" means: (1) the Canadian International Trade Tribunal and Canada Border Services Agency, (2) the International Trade Administration of the U.S. Department of Commerce, or (3) the Mexican *Secretaría de Economía*. At the option of an interested party, the final determination of an investigating authority may be challenged before a NAFTA panel to determine its consistency with domestic legislation and the NAFTA Agreement. Final determinations are definitive decisions made by investigating authorities under their

Final Determination: Dumping Made by Minister of National Revenue-Customs regarding Gypsum Board Originating from USA

(November 17, 1993)

This Binational Panel Review was conducted pursuant to Article 1904 of the *Canada–United States Free Trade Agreement* (FTA) and Part II of the ***Special Import***

Measures Act (SIMA). On April 13, 1992, Revenue Canada received a draft complaint respecting the injurious dumping of gypsum wallboard filed jointly on behalf

of three Canadian producers. Information gathered by Revenue Canada officials indicated that U.S. imports as a percentage of the total Canadian market had increased from 6.3 percent in 1989 to 12.6 percent in the first four months of 1992. As a result, a **preliminary determination of dumping** was made on September 22, 1992 (Preliminary Determination).

Issue: Period of Investigation (POI)

National Gypsum (American complainant) submits that the Final Determination of dumping issued on December 14, 1992 must be remanded by the Binational Review Panel because Revenue Canada committed an error of law in respect of its selection of the period of investigation (POI) for the examination of exports of gypsum board to Canada. Complainant also argues that Revenue Canada erred in fact and law in respect of the decision not to include certain interest expenses in the calculation of the “costs of production” of certain U.S. exporters such as National Gypsum for the purposes of determining the **normal value** of like goods.

Section 31(1) of SIMA governs the commencement of investigations respecting the dumping or subsidizing of goods into Canada:

The Deputy Minister shall cause an investigation to be initiated respecting the dumping or subsidizing of any goods on his own initiative, or, where he receives a written complaint respecting the dumping or subsidizing of the goods, within 30 days after the date on which written notice is given by the Deputy Minister to the complainant that the complaint is properly documented, if he is of the opinion:

- a that there is evidence that the goods have been or are being dumped or subsidized; and
- b that the evidence discloses a reasonable indication that the dumping or subsidizing referred to in paragraph (a) has caused, is causing or is likely to cause **material injury** to a domestic industry.

The choice of POI is a discretionary decision taken by Revenue Canada officials. However, the SIMA requires that the POI must be for a long enough period in order to capture a sufficient number of sales to determine whether dumping is occurring. Indeed, as noted in section 35(1) of SIMA, where there is insufficient evidence of dumping or subsidizing to justify proceeding with the investigation,

or if the margin of dumping or the actual or potential volume of dumped goods is negligible, the Deputy Minister shall cause an investigation to be terminated. In selecting the POI, Revenue Canada’s objective is to select a period, which accurately reflects the exporter’s price levels to Canada and in the country of export.

In the Panel’s view, National Gypsum’s argument that the decision of Revenue Canada must be the “correct” decision rather than one that is “reasonable” is not supportable. It is the Panel’s opinion in this case that the choosing of a POI is indeed a matter falling within Revenue Canada’s core area of expertise and should be given deference [American **Chevron Doctrine**]. Given Revenue Canada’s specialized role and function and the corresponding deference, which should thus be accorded to their decisions, the Panel adopts the “reasonableness” standard of review.

The issue remains of whether it was reasonable for Revenue Canada to select and/or continue with its two-month, March/April POI notwithstanding its shortness? It was argued that by including the price increase in the United States and excluding the price increase in Canada, Revenue Canada did not capture a representative picture of pricing and did not obtain the data necessary to provide a reasonable estimate of the margin of dumping. The purpose of the POI is to set a period for Revenue Canada’s fact-finding exercise. In selecting a POI, the objective is to select a period which accurately reflects the exporters’ price levels to Canada and in the country of export and in order to affirm or dispute the allegations of dumping and injury made by Canadian industry.

It is our view that, according deference to expert administrative bodies, compelling reasons would be needed to justify the choice of such an unusually short POI ending well before the initiation date of the investigation. First, Revenue Canada concluded that there were no significant trends or seasonal factors affecting imports. Our own review of the data and the material concerning the industry indicates that it was subject to seasonal trends typical of the construction industry, with larger sales at higher prices in the summer months. Based on the foregoing application of the standard of review to the facts of this case, the Panel finds that it was unreasonable for Revenue Canada to maintain the two-month, March/April POI throughout its investigation. It is hard to think of a more relevant factor in a dumping inquiry than a price increase by the major accused exporter in the importing country prior to initiation of the investigation. Yet, there is nothing in the record indicating that Revenue Canada ever considered the issue of May/June pricing.

Issue: Treatment of Interest Expense

As noted above, the standard of review by which to assess the decision of Revenue Canada with regard to the treatment of interest expenses of the exporter is the “standard of reasonableness” applied with deference. The relevant provisions of Section 19(b) of SIMA state: “The normal value of the goods shall be determined, as the aggregate of the *cost of production* of the goods; including, an amount for administrative, selling and all other costs; and an amount for profits.” The interest expenses at issue are simply part of each exporter’s general costs of doing business (financing of its capitalization) and thus must be accounted for in the calculation of normal value under paragraph 19(b). In our view, the only reasonable interpretation of the relevant provisions of SIMA is that, in calculating normal values on a **constructed-value basis**, the costs to which the profit margin is to be added are what are commonly called “total” costs. For whatever reason and however incurred, the interest expenses in question became part of the actual costs of the corporation, and are “attributable” to the goods it produces. They required payment; they were not notional or phantom costs in any sense. In calculating the net profit or loss of the company, they would be deducted as an expense. This means simply that all costs of a corporation, paid or accruing as payables, must be spread in some reasonable manner over the products of the corporation.

The statutory direction that “all other costs” are to be allocated indicates that every type of corporate expenditure, no matter how extraordinary or unrelated to production, is to be allocated to all products in some fair way. Counsel for Revenue Canada stated that they routinely allocate to exported products an *aliquot portion* (portion of total amount) of general corporate costs such as executive salaries and business insurance, even though such costs have no direct relation to the production of the exported goods. Thus costs allocations include tracing costs to the production of particular goods, and an estimated allocation by formula of “other costs.”

Our reasoning is confirmed by considering the situation in which a company makes a single undifferentiated product and has no other activities so that there would be no question of spreading interest or any other costs over more than one product or activity. In that situation, it appears clear that all costs of the company would have to be taken into account if paragraph 19(b) were applicable. The section speaks without qualification of “all other costs,” the plain meaning of which does not permit a gloss of excluding some costs of the company that may be

characterized as unusual, extraordinary or not related to producing the products of the company. Hence, if the company were to expand to several product lines, the same costs would have to be allocated among the subject goods and nonsubject goods.

Conclusion and Decision—Interest

The Panel remands the decision regarding the interest expenses of National Gypsum to the Deputy Minister of National Revenue for action not inconsistent with this decision.

Case Highlights

- Under the Canadian–American FTA, as with the NAFTA, private parties may file complaints with the appropriate government agency to investigate alleged cases of dumping or illegal subsidies.
- Following a substantive complaint, the first step in the dispute resolution process is determining the “period of investigation.” This will be the period of time that the government agency will review the import transactions subject to the complaint. The government agency (Revenue Canada) conducting this investigation has discretion in setting the POI. The exporting party may challenge the selected period, but courts will generally defer to the agency’s discretionary power (in the U.S. this is called the **Chevron Doctrine** after a Supreme Court case that recognized the expertise of government agencies in making decisions within the scope of that expertise).
- Under the *Special Import Measures Act* (SIMA), the next step is to determine the “normal value” or price of the goods to be compared to the actual price charged for the exported goods.
- The common ways for determining the price include the price charged in the exporter’s domestic market or by calculating the “costs of production” including reasonable overhead expenses and profits.
- The third step requires the government agency to determine if the dumping or illegal subsidy “has caused, is causing or is likely to cause *material injury*” to domestic industries or businesses.
- In determining normal value, “all costs” of doing business must be factored into the calculation. In this case, the Binational Review Panel held that Revenue Canada had failed to factor in a *pro rata* share of the interest costs paid by the exporting company on its general business loans (“*aliquot portion* of general corporate costs”).

domestic anti-dumping and countervailing duty laws. Specifically, final determinations are made pursuant to the *Special Import Measures Act (SIMA)* in Canada, to the *Tariff Act of 1930* in the U.S., and to Article 131 of the Mexican Constitution and certain other laws in Mexico.

NAFTA Review Panel: Certain Hot-Rolled Carbon Steel Originating in Mexico

(December 13, 1999)

This Panel was convened pursuant to Article 1904 of the North American Free Trade Agreement (NAFTA). The Determination held that certain Hot-Rolled Carbon Steel Plate originating in or exported from Mexico, People's Republic of China, Republic of South Africa, and the Russian Federation threatened to cause injury to a domestic industry. It held that the imported goods from the countries in question were not causing injury to a domestic industry, but were threatening to cause injury.

The complaint alleged that the charges against the Mexican companies should have been separately analyzed since Mexico was a NAFTA country. The importance of the issue is the **cumulative effect** of the alleged dumping from the different countries. Thus, the primary issue is whether the Mexican imports should have been the subject of a separate analysis.

SIMA Section 42(3) allows for cumulation where the: (1) margin of dumping from each of the countries in question is not insignificant; (2) the volume of the goods from each of those countries is not negligible; and (3) an assessment of dumping margins on a cumulative basis is appropriate taking into account the conditions of competition between the dumped goods from a given country, including the dumped goods from any other country or like goods of domestic producers.

The Tribunal articulated its methodology by weighing additional factors for determining whether there is a causal relationship between the dumping of any goods and the threat of injury. These factors include the following: (1) the volumes and the prices of undumped goods, (2) contraction in demand, (3) changes in patterns of consumption, (4) trade restrictive practices of and competition between foreign and domestic producers, (5) developments in technology, and (6) expert performance and productivity of the domestic industry. The Tribunal must determine whether there is a causal relationship between the dumping of the goods and the threat of material injury and must ensure that injury caused by other factors is not attributed to the dumped imports.

Finally, the Tribunal notes that in making a finding of threat of material injury to the domestic industry requires that the "circumstances in which the dumping or

subsidizing of [the subject] goods would cause injury [must be] clearly foreseen and imminent." It is interesting to note that the primary emphasis of the Complainant on the issue of causation at the hearing related to whether the Tribunal was obligated, under SIMA, to consider the effect of the dumped imports from Mexico separately from dumped imports from other countries.

Conclusion

In summary, it is clear from the Statement of Reasons that the Tribunal performed a causation analysis and considered a vast array of factual evidence in accordance with SIMA Regulations. Some of that evidence is, on its face, supportive of the causation finding. Some of the evidence is, on its face, potentially antithetical to that finding. The Tribunal looked at all of the evidence and ascribed different weight to different evidence. As such, the Complainant has not demonstrated any reviewable error on the part of the Tribunal, nor has it established that the Tribunal failed to consider any relevant evidence on the record or that the Tribunal treated any such evidence in a patently unreasonable manner.

Case Highlights

- In order to win a dumping-of-goods claim, it must be proven that the alleged dumping caused or threatened to cause injury to a domestic industry in the importing country. Alternatively stated, there has to be a causal connection between the price of the imported goods and a material injury caused to a domestic industry.
- Dumping charges may be brought against more than one country (in this case, China, Mexico, South Africa, and Russia), and the cumulative impact of the imports from all the countries may be used in making the "injury to domestic industry" determination.
- Because of the cumulative impact of the dumping of the same type of goods by companies from different countries, Mexico need not be treated separately from other countries simply because it is a NAFTA country.

A final determination may be appealed to a domestic court pursuant to the judicial review process of the country or to a binational review panel under NAFTA. The responsible section of the NAFTA Secretariat established the review panel. **Final determination** means: (1) an order of the Canadian International Trade Tribunal, (2) affirmative determination by the International Trade Administration of the United States Department of Commerce or by the United States International Trade Commission, or (3) a final resolution regarding anti-dumping or countervailing duties investigations by the *Secretaría de Economía*, pursuant to the *Mexican Foreign Trade Act*.

Panelists are chosen from rosters of experts established by the Parties in each NAFTA country. Panelists must be of high standing, good character, objective, reliable, and have sound judgement and general familiarity with international trade law. The majority of members of a panel, including the Chair, must be lawyers. One ground of appeal is panel misconduct for which an extraordinary challenge proceeding may be brought alleging that a member of the panel was guilty of gross misconduct, bias or a serious conflict of interest, or otherwise materially violated the rules of conduct.

Extraordinary Challenge Procedure

Although panel decisions are binding, there is one level of review of binational panel decisions that a NAFTA government may initiate in extraordinary circumstances. This is known as the **Extraordinary Challenge Committee (ECC)** procedure. The challenge is not an appeal of right but a safeguard to preserve the integrity of the panel process. A government to a dispute may challenge a panel's decision under the ECC procedure on three grounds: (1) belief that a decision has been materially affected by a panel member having a serious conflict of interest, (2) belief that the panel departed from a fundamental rule of procedure, or (3) belief that the panel exceeded its authority under NAFTA. Either government may invoke review by a three-person, binational ECC, comprised of judges and former judges. ECC decisions, like binational panel decisions, are binding as to the particular matter addressed.

Institutional Arrangements and Dispute Settlement Procedures

The dispute settlement provisions of NAFTA Chapter 20 are applicable to all disputes regarding the interpretation or application of NAFTA rules. The steps set out in Chapter 20 are intended to resolve disputes by agreement, if at all possible. The process begins with government-to-government consultations. If the dispute is not resolved, a Party may request a meeting of the **NAFTA Free-Trade Commission** (national trade ministers). If the Commission is unable to resolve the dispute, a consulting Party may call for the establishment of a five-member arbitral panel. Chapter 20 also provides for **scientific review boards**, which may be selected by a panel, in consultation with the disputing Party, to provide a written report on factual issues relating to environmental, health, safety, or other scientific matters to assist panels in rendering their decisions.

Panel Selection

When a dispute arises, a panel of five members is selected from the national roster lists. Each government in the dispute (through its trade minister) appoints two panelists, in consultation with the other involved government. The fifth panelist is from one of the two countries and generally alternates with each dispute. Some disputes establish an arbitral panel using a reverse selection process. Under this process, each disputing Party selects two panelists who are citizens of the other disputing Party. The chair of the panel is selected by the disputing Parties and may be a citizen of a NAFTA Party or any other country. To serve on a specific panel, roster candidates must complete Disclosure Statements pursuant to NAFTA's *Code of Conduct*. The Code is fundamental to the process. The governing principle is that a roster candidate and panel member must disclose any interest, relationship, or matter that is likely to affect her independence or impartiality or that might create an appearance of impropriety or bias.

Roster of Panelists: NAFTA panelists and committee members are not permanent arbitrators, but are established on an ad hoc basis. Pursuant to NAFTA, the Parties have established several rosters of individuals from which panelists are appointed to settle disputes.

Panel Decisions and Reports

Panels review final anti-dumping (AD) and CVD determinations solely to determine, based on the administrative record, whether the relevant administrative agency applied its national AD/CVD laws correctly. The panels will employ the same standard of review and the same general legal principles as would a domestic court in the country where the determination was made. In its decision, a panel may do one of two things. It may uphold the final determination, or it may remand it (send it back) to the investigating authority. In the latter case the panel may issue a second decision on the agency's determination on remand.

Other U.S. Free Trade Agreements

This section reviews two of the post-NAFTA FTAs: **Central America–Dominican Republic FTA (CAFTA-DR)** and the **Korea–U.S. FTA (KORUS FTA)**. The former FTA is an example of an agreement among countries at different stages of economic development. As such, the FTA contains **safeguard provisions** that provide assistance, exceptions, and delayed implementation of FTA obligations for the lesser-developed countries. The latter FTA is between two advanced economies, so the issues of differences in economic development are not as prevalent. However, the FTA often contains transitional or phased-in obligations to protect specific industries in the member countries.

CAFTA-DR (Central America–Dominican Republic FTA)

The CAFTA-DR was the first FTA between the U.S. and a group of smaller developing economies: Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic. The CAFTA-DR promotes stronger trade and investment ties, prosperity, and stability throughout the region.

Central America and the Dominican Republic represent the third largest U.S. export market in Latin America, behind Mexico and Brazil. Total two-way trade in goods between the U.S. and its six CAFTA-DR partners has increased over 71 percent since the FTA entered into force, from \$35 billion in 2005 to \$60 billion in 2013. The areas of coverage of CAFTA-DR includes an expanded menu common in the next generation FTAs: (1) National Treatment and Market Access for Goods, (2) Rules of Origin (ROO), (3) Sanitary and Phytosanitary Measures (SPS), (4) Technical Barriers to Trade (TBT), (5) Government Procurement, (6) Foreign Direct Investment (FDI), (7) Trade in Services, (8) Financial Services, (9) Telecommunications and Electronic Commerce, (10) Intellectual Property Rights (IPR), (11) Labor Rights, (12) Environment Protection, (13) Anti-Corruption, (14) Economic Sustainability, and (15) Dispute Settlement. Figure 7.4 provides excerpts from the “preamble” of the CAFTA-DR, which highlights the goals and purposes of the agreement.

Figure 7.4 illustrates the core areas and principles found in FTAs, including: expanding market access for trade in goods and services, improved transparency of customs regulations, protection of intellectual property, improvement of workers' rights, and the need to promote environmental protection and sustainable development. Importantly, as will be seen in the review below of the TPP, the CAFTA-DR FTA recognizes the differences in the member countries' levels of development and the size of their economies (see italicized phrases in the Preamble). This recognition acts as a safeguard that allows the lesser-developed member countries to ask for exceptions or delays in implementing their obligations under the FTA.

STRENGTHEN the special bonds of friendship and cooperation among their nations and promote regional economic integration; CONTRIBUTE to the harmonious development and expansion of world trade; CREATE an expanded market for their goods and services while recognizing the *differences in their levels of development and the size of their economies*; ESTABLISH clear and mutually advantageous rules governing their trade; ENSURE a predictable commercial framework for business planning and investment; SEEK to facilitate regional trade by promoting efficient and transparent customs procedures; ENHANCE the competitiveness of the countries' firms in global markets; FOSTER

creativity and innovation, and promote trade in goods and services that are the subject of intellectual property rights; PROMOTE transparency and eliminate bribery and corruption in international trade and investment; PROTECT, enhance, and enforce basic workers' rights; CREATE new employment opportunities and improve working conditions and living standards; IMPLEMENT this Agreement in a manner consistent with environmental protection and promote sustainable development; PRESERVE their *flexibility to safeguard the public welfare*; and CONTRIBUTE to hemispheric integration.

Figure 7.4 Preamble: Central America–Dominican Republic FTA (CAFTA-DR).

Korea–U.S. Free Trade Agreement (KORUS FTA): Government Procurement

In 2012, the U.S. and South Korea ratified the KORUS FTA.¹ The KORUS FTA demonstrates the comprehensiveness of modern FTAs, as it has chapters cover: (1) Trade in Goods in general and by industrial sectors including, Agriculture, Textiles and Apparel, and Pharmaceuticals and Medical Devices; (2) Trade in Services; (3) Investment; (4) Financial Services; (5) Telecommunications; (6) Electronic Commerce; (7) Competition Law (Antitrust); (8) Intellectual Property Rights; (9) Labor Law and Rights; (10) Government Procurement; and (11) Environmental Protection.

The Agreement contains government procurement provisions in which both countries agree to open their procurement markets to each other. U.S. firms interested in the Korean procurement market will find it difficult to penetrate the market due to low price competition, while Korean companies are likely to be competitive in the U.S. procurement market. U.S. companies are more competitive in some service sectors. U.S. firms should consider strategic alliances with Korean firms to obtain government services contracts.

Government procurement or public procurement is the purchasing of goods and services on behalf of a public authority, such as a government agency. Between 10–20 percent of national gross domestic product (GDP) worldwide is attributable to government procurement, accounting for a substantial part of the global economy.

Both Korea and the U.S. are members of the WTO's Government Procurement Agreement, but FTAs allow countries to negotiate more liberal rules than provided by the WTO Agreement. In the case of government procurement, the KORUS FTA provides greater access to foreign government procurement by lowering the threshold amount of the contracts that foreign firms are allowed to bid upon. U.S. and Korean countries may bid on government contracts as low as \$100,000. It is also important for American exporters to note that English must be the primary language used in most procurement processes. However, most contracting officers in Korea do not speak English fluently, so using local Korean agents or representatives would be prudent.

Future Free Trade Agreements

The U.S. has concluded an Asia-Pacific free trade agreement, known as the Trans-Pacific Partnership (TPP), and is negotiating the Transatlantic Trade and Investment Partnership (T-TIP) with the European Union.

Trans-Pacific Partnership (TPP)

President Obama announced in November 2009 the U.S.' intention to participate in the TPP negotiations to conclude an ambitious, next-generation, Asia-Pacific trade agreement. The United States has concluded an

agreement with eleven countries: Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam. Member countries to TPP represent nearly 40 percent of global GDP. U.S. exports to TPP countries totaled \$698 billion in 2013, representing 44 percent of total U.S. goods exports. As a group, the TPP countries are the largest goods and services export market for U.S. small- and medium-sized enterprises, which alone exported \$247 billion to the Asia-Pacific Rim. In 2015, the Obama Administration obtained “fast track” authority from Congress allowing for a final negotiations and swift approval of TPP. “Fast track” prohibits Congress from making amendments to the final agreement and requires a simple majority vote for passage. The TPP was signed by the U.S. and eleven other Pacific Rim countries on February 4, 2016 in Auckland, New Zealand, after seven years of negotiations.

The major coverage areas of TPP include, along with the reduction of tariffs, streamlining import procedures and removing nontariff trade barriers. In the area of customs, TPP seeks to establish customs procedures that are predictable, transparent, and that expedite trade, which will help link TPP firms into regional production and supply chains. In cross-border services, TPP seeks to institute fair, open, and transparent markets for trade in services, including services supplied electronically and by small- and medium-sized enterprises, while preserving the right of governments to regulate in the public interest. E-commerce provisions address customs duties in the digital environment, authentication of electronic transactions, and consumer protection. Financial services provisions will improve transparency, nondiscrimination, fair treatment of financial services, and investment protections. In the area of government procurement, TPP recognizes the need to facilitate the opening of the procurement markets of developing countries through the use of transitional measures. It establishes a common set of rules of origin to determine whether a product originates in the TPP region.

The TPP will seek to build upon the WTO’s **Sanitary and Phytosanitary (SPS) measures** regime in order to enhance animal health, plant health, and food safety, as well as commitments on science, transparency, and regionalization. In the area of technical barriers to trade (TBT), the Agreement will include commitments on compliance periods, conformity assessment procedures, international standards, transparency, and regulatory cooperation. Telecommunication provisions will promote competitive access for telecommunications providers. In addition to broad agreement on the need for reasonable network access for suppliers through interconnection and access to physical facilities, it will require transparency in the countries’ regulatory processes.

The non-trade areas covered include: (1) competition (antitrust) law, (2) environmental protection, (3) intellectual property rights protection, (4) labor rights, and (5) capacity building. TPP provisions will establish competition laws, including procedural fairness in competition law enforcement, transparency, consumer protection, private rights of action, and technical cooperation. Environment proposals are being negotiated on a wide variety of issues, such as, marine fisheries, conservation, biodiversity, invasive alien species, climate change, and environmental goods and services. The TPP commits member countries to reinforce and develop existing rights and obligations under the WTO’s Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). **Capacity building** recognizes that the countries of the TPP are at different stages of development and will need the assistance of the more developed countries, as well as protections and safeguards in transitioning to higher environmental and labor standards.

The other two major areas of coverage are investment protections and market access. Foreign investment will be protected by provisions to ensure nondiscrimination, a minimum standard of treatment, rules on expropriation, and prohibitions on specified performance requirements that distort trade and investment. Market access for foreign goods includes tariff reduction beyond the partners’ current WTO obligations, as well as elimination of nontariff measures that can serve as disguised trade barriers, such as import licensing.

Transatlantic Trade and Investment Partnership (T-TIP)

The T-TIP is an ambitious, comprehensive, and high-standard trade and investment agreement being negotiated between the U.S. and the European Union (EU). T-TIP will increase U.S. exporters and investors’ opportunities through increased access to European markets for Made-in-America goods and services. The U.S. and EU economies are two of the most modern, most developed, and most committed to high standards of consumer

protection in the world. T-TIP aims at providing greater compatibility and transparency in trade and investment regulations, while maintaining high levels of health, safety, and environmental protection.

Trade in Goods

The United States ships more than \$730 million in goods to the EU every day. In today's highly competitive global marketplace, even small increases in a product's cost due to tariffs can mean the difference between winning and losing a contract. T-TIP's objective is the eventual elimination of all tariffs and other duties and charges on trade in agricultural, industrial, and consumer products between the U.S. and the EU, except for transition periods where necessary for sensitive products, and appropriate safeguard mechanisms to be applied if and where necessary.

With the elimination of EU tariffs on industrial products, including innovative and high technology products such as industrial and electrical machinery, precision and scientific instruments, and chemicals and plastics, U.S. products will be more competitive in the EU versus other countries that already have FTAs with the EU (including Chile, Mexico, South Korea, and South Africa).

The U.S. is the world's largest agricultural export economy. Eliminating tariffs would provide a level playing field for its agricultural producers. For example, U.S. apple exporters pay more than 7 percent in duties when shipping to the EU. Eliminating tariffs and quotas will help U.S. farmers, ranchers, manufacturers, and workers, while giving Europeans access to safe, high-quality American food and agricultural goods.

Nontariff Barriers and Regulatory Issues

Nontariff barriers (NTBs) can decrease market opportunities for exports and provide unfair competitive advantages to EU products. These barriers take the form of restrictive licensing, permitting, and other requirements applied *at* the border, but also barriers *behind* the border, such as unwarranted TBT and SPS measures. T-TIP seeks to identify ways to reduce the costs associated with regulatory differences by promoting greater compatibility between EU–U.S. systems. This requires the elimination of unwarranted SPS restrictions that are not based on science (see the *United States v. European Community* case involving genetically modified foods in Chapter 5), unjustified TBT, and other “behind-the-border” barriers, including permit and licensing barriers. Increased compatibility of U.S. and EU regulations and related standards development (health, safety, and environmental protection) is needed. T-TIP follows a common practice in FTAs of identifying and reasserting WTO principles and obligations including the TBT Agreement, increasing market access, and commitment to base SPS measures on science and international standards. T-TIP would ensure that U.S. agencies and trade associations are permitted to test and certify products sold in Europe, and promote EU recognition of international standards used to support global trade by U.S. exporters and producers. With respect to SPS, rules governing agricultural and food products must be unbiased and be based on science so that they do not act as disguised barriers to trade aimed at protecting domestic farmers.

Trade in Services

The U.S. is the largest services exporter in the world, and services industries account for four out of five U.S. jobs. Reducing barriers by open and transparent rules relating to trade in services will benefit U.S. startups by increasing access to otherwise unreachable customers. Financial services are also an important component of the transatlantic economy. A successful T-TIP will increase financial services market access to the EU as well as provide consumers with access to high-quality financial services and greater choice with regard to suppliers. In the area of Electronic Commerce and Information and Communication Technology (ICT) Services, T-TIP would preclude the imposition of customs duties on digital products or unjustifiably discriminate among products delivered electronically. This will improve market access to U.S. retailers and service providers, filmmakers,

musicians, and software developers to sell their movies, music, video games, and other digital products to Europe's more than 500 million consumers.

Other types of agreements commonly used that fall far short of the creation of a free trade area but aim to improve trade and investment cooperation between countries, are the "Cooperation Agreement" and the "bilateral investment treaty," which are discussed below.

Bilateral Investment Treaties

The U.S. BIT program helps to protect private investment, to develop market-oriented policies in partner countries, and to promote U.S. exports. The BIT program aims to: (1) protect investment abroad in countries where investor rights are not already protected through existing agreements (such as modern treaties of friendship, commerce, and navigation, or FTAs); (2) encourage the adoption of market-oriented domestic policies that treat foreign private investment in an open, transparent, and nondiscriminatory way; and (3) support the development of international legal standards consistent with these objectives.

U.S. BITs provide American investors with six core benefits. First, U.S. BITs require that investors and their "covered investments" (that is, investments of an individual or company of one of the BIT countries in the territory of the other country) be treated as favorably as the host country treats its own investors and the investments from any third-party country. The BIT requires that investors receive the better of national treatment or most-favored-nation treatment for the entire duration of the investment (from establishment or acquisition, through management, operation, and expansion, to disposition or liquidation). Second, BITs establish clear limits on the **expropriation** of investments and provide for payment of prompt, adequate, and effective compensation when expropriation takes place. Third, BITs provide for the transferability of investment-related funds (repatriation) into and out of a host country without delay and using a market rate of exchange. Fourth, BITs restrict the imposition of **performance requirements**, such as local content rules (require a percentage of the materials used in producing goods in the foreign country to be from that foreign country) or export quotas, as a condition for the establishment, acquisition, expansion, management, conduct, or operation of an investment. Fifth, BITs give investors the right to engage the top managerial personnel of their choice, regardless of nationality. Sixth, BITs give investors the right to submit an investment dispute against the host government to international arbitration. Investment disputes with the host government may be brought by investors, or by their subsidiaries, to binding international arbitration as an alternative to domestic courts.

The U.S. negotiates BITs on the basis of a model text used by most countries. It currently maintains BITs with Argentina, Bangladesh, Bulgaria, Czech Republic, Egypt, Jamaica, Jordan, the Baltic countries (Estonia, Latvia, Lithuania), Mongolia, Panama, Poland, Romania, Tunisia, Turkey, Ukraine, and Uruguay, among others. The model BIT and its core provisions will be examined via the Estonia–U.S. Bilateral Investment Treaty.

Estonia–U.S. Bilateral Investment Treaty

The Estonia–U.S. Bilateral Investment Treaty entered into force on February 16, 1997. This BIT was executed prior to the accession of Estonia into the EU. The treaty was amended to reduce the possibility of conflict with the laws of the EU. The Treaty focuses on one type of international business—foreign direct investment (FDI). The representatives of the U.S. that negotiated the treaty were the Office of the U.S. Trade Representative and the Department of State jointly, with assistance from the Departments of Commerce, Treasury, and the Overseas Private Investment Corporation (OPIC). The transmittal letter from President Clinton to the U.S. Senate noted:

This bilateral investment Treaty with Estonia is the first such Treaty between the United States and a Baltic state. This Treaty will protect U.S. investors and assist the Republic of Estonia in its efforts to develop its economy by creating conditions more favorable for U.S. private investment and thus strengthening the development of the private sector. The Treaty is fully consistent with U.S. policy toward international and

domestic investment. A specific tenet of U.S. policy, reflected in this Treaty, is that U.S. investment abroad and foreign investment in the U.S. should receive national treatment. Under this Treaty, the Parties also agree to international law standards for expropriation and compensation for expropriation; free transfer of funds associated with investments; freedom of investments from performance requirements; fair, equitable and most-favored-nation treatment; and the investor's freedom to choose to resolve disputes with the host government through international arbitration.

The objectives of the Treaty are to protect American investments in Estonia by requiring that American investments receive national treatment and most-favored-nation treatment. Performance requirements may not be imposed upon or enforced against investments. Expropriation can occur only in accordance with international law standards; that is, the expropriation must be for a public purpose; be applied in a non-discriminatory manner; in accordance with due process of law; and upon payment of prompt, adequate, and effective compensation. The unrestricted transfer, in a freely usable currency, of funds related to an investment is guaranteed.

The Treaty's definition of investment is broad, recognizing that investment can take a wide variety of forms. It covers investments that are owned or controlled by nationals or companies of one of the Treaty partners in the territory of the other. Investments can be made either directly or indirectly through one or more subsidiaries, including companies controlled in other countries. Ownership of over 50 percent of the voting stock of a company conveys control, but a smaller proportion of ownership may be sufficient to bring a claim in arbitration against the host country.

Article II contains the Treaty's major obligations with respect to the treatment of investment. Paragraph 1 generally ensures the better of most-favored-nation or national treatment in both the entry and post-entry phases of investments. It thus prohibits both the screening of proposed foreign investment on the basis of nationality and discriminatory measures once the investment has been made.

Paragraph 2 is designed to ensure that a country cannot utilize state-owned or controlled enterprises to circumvent its obligations under the Treaty. To this end, it requires each country to observe its Treaty obligations even when it chooses, for administrative or other reasons, to assign some portion of its authority to a state enterprise, such as the power to expropriate, grant licenses, approve commercial transactions, or impose quotas, fees, or other charges.

Paragraph 3 guarantees that investment shall be granted "fair and equitable" treatment. It also prohibits a country from impairing, through arbitrary or discriminatory means, the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of a foreign investment. This paragraph sets out a minimum standard of treatment based on customary international law. Neither country may impose additional requirements such as those conditioning investment on the export of goods produced or the need to purchase local goods or services (content or performance requirements).

Under the U.S. federal system, 50 States of the United States may, in some instances, treat out-of-State residents and corporations in a different manner than they treat in-State residents and companies. The Treaty provides that the national treatment commitment, with respect to the States, means treatment no less favorable than that provided to U.S. out-of-State residents and corporations. The most-favored-nation obligation does not apply to advantages accorded by either country to third countries by virtue of a country's membership in an FTA or customs union. The FTA exception in the BIT is analogous to the exception provided in the WTO Agreement relating to FTAs.

Article III incorporates into the Treaty the international law standards for expropriation and compensation. These rights also apply to direct or indirect state measures "tantamount to expropriation or nationalization," and thus apply to *creeping expropriation* (changes in government regulations or taxes) that result in a substantial deprivation of the benefit of an investment without the formal taking of title to the investment. Compensation must be equivalent to the fair market value of the expropriated investment immediately before the expropriatory action was taken, be paid without delay, and include interest at a commercially reasonable rate from the date of expropriation.

The countries agree to permit “fund transfers related to an investment to be made freely and without delay into and out of its territories.” Transfers are to be made in a “freely usable currency” at the prevailing market rate of exchange on the date of transfer with respect to spot transactions in the currency to be transferred. Freely usable is a standard of the International Monetary Fund (IMF); at present there are six freely usable currencies: the U.S. dollar, Japanese yen, European euro, Swiss franc, Chinese yuan, and British pound sterling.

Article VI on dispute resolution provides that the disputants should initially seek to resolve the dispute by consultation and negotiation, which may include nonbinding third-party procedures. Should such consultations fail, the investor must make an exclusive and irrevocable choice to: (1) employ one of the several arbitration procedures outlined in the Treaty, (2) submit the dispute to procedures previously agreed upon by the investor and the host country government, or (3) submit the dispute to the local courts or administrative tribunals of the host country. The investor may consent to submission of the dispute for binding arbitration to either ICSID (if the host country has joined the Centre) or ad hoc arbitration using the UNCITRAL Arbitration Rules. It also provides that a non-ICSID arbitration shall take place in a country that is a party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention). This requirement enhances the ability of investors to enforce their arbitral awards.

U.S. BITs allow for **sectoral** (industry) **exceptions** to national and most-favored-nation treatment. The U.S. exceptions from national treatment include: air transportation, ocean and coastal shipping, banking, insurance, securities and other financial services, government grants, government insurance and loan programs, energy and power production, customhouse brokers, ownership of real property, ownership and operation of broadcast or common carrier radio and television stations, ownership of shares in the Communications Satellite Corporation, common carrier telephone services, submarine cable services, use of land and natural resources, mining on the public domain, and maritime and maritime-related services. Ownership of real property, mining on the public domain, maritime and maritime-related services, and primary dealership in U.S. government securities are excluded from most-favored-nation as well as national treatment commitments. Some of these exceptions relate to the **requirement of reciprocity**. Reciprocity provisions deny both national and most-favored-nation treatment in these areas to countries that do not provide access to American companies to their respective markets. For more on BITs, see Chapter 20 on “Foreign Direct Investment.”

Cooperation Agreements

Cooperation Agreements are called by different names. The two most common names are the Trade and Investment Framework Agreements (TIFAs) or Trade and Investment Cooperation Agreement (TICA), which provide strategic frameworks and principles for dialogue on trade and investment issues between the U.S. and the other parties to the TIFA or TICA. Other names include the Trade, Investment, and Development Cooperative Agreement (TIDCA) with the South African Customs Union and the U.S.–Icelandic Forum; these agreements all serve as a forum for the U.S. and other governments to meet and discuss issues of mutual interest with the objective of improving cooperation and enhancing opportunities for trade and investment. The **Trade Councils** set up by these agreements consult on a wide range of issues related to trade and investment. Topics for consultation and possible further cooperation include market access issues, labor rights, the environment, protection and enforcement of intellectual property rights, and, in appropriate cases, capacity building, if the Agreement is between a developed country and a lesser developed country. The Trade Councils normally meet at least once a year at senior levels of government. See Figure 7.5 *Comparative Law*: “Cooperation Agreements,” which provides excerpts from the EU–Georgia Partnership and Cooperation Agreement.

The standard U.S. Cooperation Agreement is about four pages in length. As an example, the 2006 TIFA between the U.S. and Vietnam contains only seven articles. Article Two is the most important since it establishes a joint committee (Council) to encourage a continuing dialogue between the former enemies: “The parties establish a U.S.–Vietnam Council on Trade and Investment to be jointly chaired by the **U.S. Trade Representative (USTR)** and the Ministry of Trade of Vietnam.” The Council is imbued with the following responsibilities: monitor trade

DESIROUS of encouraging the process of regional cooperation in the areas covered by this Agreement with neighboring countries in order to promote the prosperity and stability of the region;

BEARING IN MIND the utility of a wider area of cooperation in Europe and neighboring regions and its progressive integration into the open international system;

CONSIDERING the commitment of the Parties to liberalize trade, in conformity with World Trade Organization (WTO) rules, THE PARTIES HAVE AGREED AS FOLLOWS:

Article 2: Respect for democracy, principles of international law, and human rights as defined in particular in the United Nations Charter, the Helsinki Final Act, and the Charter of Paris for a New Europe, as well as the principles of market economy.

Article 9: The Parties shall accord to one another most-favored-nation treatment in all areas in respect of customs duties and charges applied to imports and exports, including the method of collecting such duties and charges; provisions relating to customs clearance, transit, warehouses and transshipment; taxes and other internal charges of any kind applied directly or indirectly to imported goods; methods of payment and the transfer of such payments; and the rules relating to the sale, purchase, transport, distribution, and use of goods on the domestic market.

Article 42: Pursuant to the provisions of this Article, Georgia shall continue to improve the protection of intellectual, industrial, and commercial property rights in order to provide for a level of protection similar to that existing in the European Community, including effective means of enforcing such rights.

Article 57: Cooperation shall aim at combating the deterioration of the environment and in particular the effective monitoring of pollution levels and assessment of the environment; system of information on the state of the environment; combating local, regional, and transboundary air and water pollution; safety of industrial plants; classification and safe handling of chemicals; and global climate change.

Article 66: The Parties will enter into close cooperation aimed at achieving compatibility between their systems of consumer protection. This cooperation may include the improvement of information provided to consumers especially on prices, and characteristics of products and services offered and increasing the compatibility of consumer protection policies.

Article 89: Within the limits of their respective powers and competencies, the Parties shall encourage the adoption of arbitration for the settlement of disputes arising out of commercial and cooperation transactions and to arbitration by any center of a State signatory to the Convention on Recognition and Enforcement of Foreign Arbitral Awards (New York Convention).

Figure 7.5 *Comparative Law:* Cooperation Agreements.

Partnership and Cooperation Agreement between the EU and Georgia. [Selected Provisions.]

and investment between the two countries, identify and work to eliminate impediments to trade, seek the advice of the business community, and discuss specific matters referred to the Council by either country. An annex to the agreement provides a list of issues to be discussed by the Council, such as protection of intellectual property rights, internationally recognized labor rights, TBT, and technical assistance and capacity building. Examples of other Cooperation Agreements that are in the process of negotiations are discussed below.

The Australia–India Comprehensive Economic Cooperation Agreement has been the subject of a decade of negotiations. The two countries aim to enter into a comprehensive agreement that would broaden the base of merchandise trade by reducing tariff barriers and “behind the border” restrictions on trade in goods, as well as facilitating growth in services trade by reducing barriers faced by Australian service suppliers and by increasing regulatory transparency. The counties involved in negotiating the **Asia-Pacific Economic Cooperation (APEC)** agreement include countries that border the Pacific Ocean: Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, Taiwan, Thailand, and Vietnam. Its purpose is to increase negotiations between all member nations concerning common trade issues. The APEC economies comprise 44 percent of world trade and 54 percent of global GDP. In 2010, nine of the top export markets for the U.S. were APEC members, accounting for 60 percent of U.S. exports.

Highlights

- The above Cooperation Agreement restates many of the requirements needed to join the EU including “respect for democracy, principles of international law, and human rights.”
- It directs Georgia to conform to the major international conventions and principles as it transitions from the sphere of influence of the former Soviet Union to a potential member of the EU. It notes the importance of the United Nations Charter, as well as the New York Convention on the enforcement of arbitration awards (see Chapter 4 on “International Commercial Dispute Resolution”).

- In the area of trade, it commits the EU and Georgia to the application of the most-favored-nation principle, compliance with WTO rules, and encourages Georgia to bring its intellectual property protections, environmental regulations, and consumer protection laws up to international (European) standards.

Free Trade Zones

Free trade zones are located throughout the world. This section will review their purposes and benefits from the perspective of American **Foreign Trade Zones (FTZs)**. FTZs are secure areas under the supervision of the U.S. **Customs and Border Protection (CBP)**. FTZs are located within the national boundaries or territories of the U.S. but are generally considered outside U.S. territory for purposes of the importation of goods. Located in or near ports of entry, foreign trade zones are America's version of what are known internationally as free trade zones. Authority for establishing these facilities is granted by the **Foreign-Trade Zones Board** under the Foreign-Trade Zones Act of 1934. The Foreign-Trade Zones Act is administered through two sets of regulations, the FTZ Regulations and CBP Regulations. Foreign and domestic merchandise may be moved into FTZs for operations, including storage, exhibition, assembly, manufacturing, and processing. FTZs are subject to the laws and regulations of the U.S. as well as those of the states and communities in which they are located.

Under FTZ procedures, the usual formal CBP entry procedures and payments of duties are not required on foreign merchandise unless and until the goods exit the FTZ for domestic consumption, at which point the importer generally has the choice of paying duties at the rate of either the original foreign materials entered into the FTZ or the finished product (produced in the FTZ). Domestic goods moved into the zone for export may be considered exported upon admission to the zone for purposes of excise tax rebates and **drawbacks**. Drawbacks are refunds of duties or fees previously paid. For example, an American company imports materials or component parts and pay tariffs, then uses those imported goods to produce a new product, which then enter into the FTZ for future exporting. At the time of entering their products into the FTZ the company can request a refund for the previous tariffs paid. There are also **duty deferral** programs related to NAFTA that include FTZs, temporary importations under bond, bonded warehouses, *maquiladoras* (assembly plants in Mexico along the Mexico–American border), and inward processing programs. NAFTA provides a new method for duty deferral with respect to importations of goods that are subsequently exported to another NAFTA country. Upon exportation, the goods will be treated as if withdrawn for domestic consumption, thus subject to the applicable customs duties. The customs administration assessing such duties may waive or reduce them by an amount that does not exceed the total custom duties paid to the NAFTA country to which the goods are exported. Such reduction or waiver will be made when the claimant presents satisfactory evidence of the customs duties paid in the NAFTA country to which the goods were exported. The claimant has 60 days to present satisfactory evidence, otherwise the customs administration of the exporting country will collect the duties. Should a claimant subsequently obtain satisfactory evidence, the duties may be refunded to the extent allowed, upon timely presentation of the evidence according to the laws and regulations of each NAFTA country.

FTZ operations are conducted on a public utility basis, with published rates. A typical general-purpose zone provides leasable storage-distribution space to users in general warehouse-type buildings with access to various modes of transportation. Many FTZs include an industrial park site with lots on which zone users can construct their own facilities. Subzones are normally private plant sites authorized by the Foreign-Trade Zones Board.

Advantages of Using a Foreign Trade Zone

The two major issues related to FTZs are what type of goods may be entered and what can be done within the FTZ. As to the first issue, any foreign or domestic merchandise not prohibited by law or other exception, whether dutiable or not, may be taken into a FTZ. Merchandise for which a **quota** is filled or for which a quota on entry is established, may be placed into a zone until the quota opens or is removed, since FTZs are considered outside CBP territory for entry purposes. Also, products, with the exception of certain textiles, may be manipulated, assembled, or manufactured into a product not subject to quota, while in the zone.

Import Quotas: There are two types of quotas: (1) a physical or “absolute quota” and (2) “tariff rate quota.” The former type limits the quantity of certain goods that may enter a country during a specific period. The latter type permits a specified quantity of imported merchandise to be entered at a reduced tariff rate during the quota period, however quantities entered in excess of the quota limit during that period are subject to a higher tariff rate.

As to the second issue, no retail trade of foreign merchandise may be conducted in a FTZ. However, foreign and domestic merchandise may be stored, examined, sampled, and exhibited in a zone. The rate of duty and tax on the merchandise admitted to a zone may change as a result of operations conducted within the zone. Therefore, the zone user who plans to enter the merchandise for consumption to CBP territory (import the goods) may normally elect to pay either the duty rate applicable on the foreign material placed in the zone or the duty rate applicable on the finished article transferred from the zone, whichever is to its advantage. CBP duty and federal excise tax, if applicable, are paid when the merchandise is transferred from the zone and entered into the country for sale. Goods may be exported to another country from the zone free of duty and excise tax. Merchandise may remain in a zone indefinitely, whether or not subject to duty. CBP security requirements provide protection against theft.

Role of CBP

CBP is responsible for the transfer of merchandise into and out of the FTZ and for matters involving the collection of revenue. The Office of Regulations and Rulings at CBP Headquarters provides legal interpretations of the applicable statute, CBP Regulations, and procedures.

The Port Director of CBP, in whose port a zone is located, is charged with overseeing zone activity as the local representative of the Foreign-Trade Zones Board. He or she controls the admission of merchandise into the zone, the handling and disposition of merchandise in the zone, and the removal of merchandise from the zone. In addition to the Foreign-Trade Zones Act, he or she enforces all laws normally enforced by the CBP that are relevant to foreign trade zones.

Privileged Foreign Status and Domestic Status

Prior to any manipulation or manufacture, which would change its tariff classification, an importer may apply to the Port Director to have imported merchandise in the zone given **privileged foreign status**. The merchandise is classified and appraised, and duties and taxes are determined as of the date the application is filed. When such merchandise is transferred from the zone for U.S. consumption, either in its original state or after manipulation or manufacture, the applicable duties and taxes would be paid based on the rate established when privileged foreign status was granted. This would be beneficial if the importer fears that the tariff rate might be increased in the future.

Domestic status, which may be approved upon application to the Port Director, is available for merchandise that is (1) grown, produced, or manufactured in the U.S. on which all internal revenue taxes, if applicable, have been paid; (2) previously imported merchandise on which all internal revenue taxes have been paid; or (3) merchandise previously admitted free of duty. Domestic merchandise may be admitted to a zone without a CBP permit, and also removed from a zone without a CBP permit if it has not been combined with any other merchandise of a different status.

Chapter Summary

- 1 Free trade agreements (FTAs) are exceptions to the WTO’s most-favored and national treatment principles (Article of XXIV of the General Agreement on Tariffs and Trade) in that two or more countries may enter into an FTA to provide lower tariff rates to each other than the normal WTO rates.

- 2 Bilateral investment treaties (BITs) are binding agreements between two countries that provide assurances to one another's citizens, companies, and investors doing business in each other's country. They primarily protect foreign investment from expropriation or creeping expropriation and allow private companies to bring a claim against the host country through international arbitration.
- 3 Free or foreign trade zones (FTZs) are specially designated areas within a country that are "outside" the country for purposes of assessing and collecting tariffs and import fees. Goods may be further processed in the FTA and then imported into the country or reexported to another country.
- 4 Rules of Origin (ROO) are a key component of FTAs in that they determine which products are "regional goods" that benefit from the preferential rates provided by the FTA. Products are NAFTA or regional goods if they originated in a NAFTA country (grown or produced) or are made of materials from other countries that have been "substantially transformed" in a NAFTA country and/or meet certain content requirements (percentage of the value of the products need to be attributed to a NAFTA country or countries).
- 5 The NAFTA dispute resolution process begins when national agencies (Investigating Authority) decide to investigate imports that may be cases of the dumping of goods below "normal value" or market prices, or have benefited from illegal government subsidies of the exporting country. Government agencies may also respond to private complaints in commencing investigations. Agencies "final determinations" to access anti-dumping or countervailing duties may be appealed to a Binational Review Panel. Some Panel decisions (Panel or Panel member misconduct) may be appealed to the Extraordinary Challenge Committee (ECC).
- 6 In order to prove a case of the dumping of goods, the complainant and Investigating Authority must prove that the goods were priced below the market price of products and the selling of the goods caused, was causing, or threatened to cause material injury to a domestic industry.
- 7 FTAs between countries at different levels of development, such as the Central America–Dominican Republic FTA (CAFTA-DR FTA) and Trans-Pacific Partnership (TPP), to be successful need to contain safeguard and snapback provisions, as well as capacity building obligations, to assist the lesser-developed countries to meet their FTA obligations.
- 8 FTZs are very useful to exporting or importing companies for avoiding or deferring the payment of tariffs, to drawback duties previously paid, and for warehousing or processing of goods.

Key Terms

Anti-Dumping Duties	Cumulative Effect	Illegal Government Subsidies
Asia-Pacific Economic Cooperation (APEC)	Customs and Border Protection (CBP (U. S.))	International Trade Administration (ITA)
Belarus–EU Partnership and Cooperation Agreement	Domestic Status	International Trade Commission (ITC)
Bilateral Investment Treaties (BITs)	Drawback (Tariffs)	Investigating Authority
Binational Review Panels	Duty Deferral (Tariffs)	Korea–U.S. Free Trade Agreement (KORUS FTA)
Capacity Building	Estonia–U.S. Bilateral Investment Treaty	Material Injury
Central America–Dominican Republic FTA (CAFTA-DR)	Expropriation	NAFTA Free-Trade Commission
<i>Chevron</i> Doctrine	Extraordinary Challenge Committee (ECC)	NAFTA Secretariat
Constructed-Value Basis	Final Determination	Nontariff Barriers (NTBs)
Cooperation Agreement	Foreign-Trade Zones Board	Normal Value
Countervailing Duties	Free or Foreign Trade Zone (FTZ)	North American Free Trade Agreement (NAFTA)
Court of International Trade (U.S.)	Free Trade Agreements (FTAs)	Performance Requirements
	Government Procurement	

Period of Investigation (POI)	Sanitary and Phytosanitary Measures (SPS)	<i>Tariff Act of 1930</i>
Preliminary Determination of Dumping	Scientific Review Boards	Trade Councils
Privileged Foreign Status	Sectoral Exceptions	Transatlantic Trade and Investment Partnership (T-TIP)
Public Procurement	Snapback Provision	Trans-Pacific Partnership (TPP)
Quota	Special Import Measures Act (SIMA) (Canada)	Triple Transformation
Reciprocity, Requirement of Regional or Qualified Goods	Substantial Transformation	U.S. Trade Representative (USTR)
Rules of Origin (ROO)		
Safeguard Provisions		

Chapter Problems

- What are the differences between free trade agreements and bilateral investment treaties?
 - What are free trade zones, and what benefits do they provide to manufacturers or suppliers and the host country?
 - What are the differences between NAFTA and the common market of the European Union? See Chapter 8 on the “European Union.”
 - Match the items on the right column with the appropriate items on the left column (answers over the page):
-
- | | |
|-----------------------------------|--------------------------------------------|
| i Rules of Origin | a Host Country Laws |
| ii Regional Goods | b Government Procurement of \$100,000 |
| iii Foreign Trade Zone | c ECCN |
| iv ICSID | d Binational Review Panels |
| v Creeping Expropriation | e Bilateral Investment Treaties |
| vi Technical Barriers to Trade | f Substantial Transformation |
| vii Export Control Classification | g Investor-Country Arbitration Association |
| viii NAFTA Disputes | h Customs and Border Protection (CBP) |
| ix KORUS FTA | i “Behind-the-Border” Barriers |
| x Foreign Direct Investment | j Goods from FTA Countries |
-
- Outside of the preferential tariffs rates offered under free trade agreements, there are a number of worldwide and preferential tariff rates offered to lesser-developed countries under such instruments as the generalized system of preferences (GSP), Caribbean Basin Initiative (CBI), Andean Trade Preference Act (ATPA), and African Growth and Opportunity Act (AGOA). Find out which countries are offered these lower tariff rates, on which types of goods, and the lower tariff rate offered. See generally, the Office of the U.S. Trade Representative (USTR) at ustr.gov; more specifically, see https://help.cbp.gov/app/answers/detail/a_id/586/kw/trade.
 - Look up the products linked to the following harmonized tariff schedule (HTS) classification numbers and answer the questions posed above in Question 5: 0902.10.10 (“flavored tea” in Chapter 9 of the HTS) and 4101.90.40 (“raw hide, vegetable pretanned” in Chapter 41 of the HTS). The HTS can be found at <http://www.usitc.gov/tata/hts/bychapter/index.htm>. Note: There are three columns under the title “Rates of Duties”; the first column marked “General” is the WTO rate, the second column marked “special” are the preferential rates (below WTO rates), and column 3 marked “2” gives the non-WTO rates (assessed against nonmember countries).

Internet Exercises

- 1 For more information on technical barriers to trade (TBT), visit www.ustr.gov/trade-agreements/wto-multilateral-affairs/wto-issues/technical-barriers-trade.
- 2 For more information on sanitary and phytosanitary (SPS) measures, visit: https://www.wto.org/english/res_e/booksp_e/agrmntseries4_sps_e.pdf.
- 3 NAFTA allows private companies to file complaints of alleged dumping of goods and to request an investigation under NAFTA investigation procedures. Review one of the following sites to see the requirements for filing a complaint and the evidence required to be shown to instigate an investigation: <http://www.cbsa-asfc.gc.ca/sima-lmsi/complaint-plainte-eng.html> (Canada); <http://ia.ita.doc.gov/admanual/index.html> (U.S.), and <http://ia.ita.doc.gov/filing/index.html> (Mexico).
- 4 For information on trade in services, visit <https://ustr.gov/issue-areas/services-investment/services>.
- 5 How can U.S. companies identify tariffs on exports to FTA partner countries? Pick a product and use export.gov's "FTA Tariff Tool" to determine the tariff, or tax at the border, that U.S. FTA partners will collect when a U.S. exported product enters the country. You can look up the tariff rate for a given product, as well as identify when in the future the tariff rate will go down further or be eliminated altogether. See <http://export.gov/FTA/ftatarifftool/index.asp>.

Other Internet Sources

NAFTA Secretariat: <http://www.nafta-sec-alena.org> (rules, decisions, reports).

NAFTA resources: <http://lanic.utexas.edu/la/mexico/nafta>.

Europa—The European Union Online: <http://europa.eu>.

[Answers to Problem 4: i (f), ii (j), iii (h), iv (g), v (a), vi (i), vii (c), viii (d), ix (b), x (e).]

Note

- 1 Hong-Sik Chung, "Government Procurement in the United States–Korea Free Trade Agreement: Great Opportunities for Both Sides?" 34 *Northwestern Journal of International Law & Business* 299 (2014).

Part III

DOING BUSINESS IN THE EUROPEAN UNION AND CHINA



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THE EUROPEAN UNION

The **European Union (EU)** consists of 28 countries with a combined population of 508 million. Geographically, it covers Western Europe, including the United Kingdom and Ireland; Central Europe, including Germany and Poland; and Eastern Europe, including the Baltic States, Hungary, Romania, and Bulgaria, and the Scandinavian countries of Denmark, Finland, and Sweden. Croatia became the 28th member of the EU in 2013. See Figure 8.1: “Map of the European Union.” The EU taken as a whole is one of the three major trading powers in the world, along with the U.S. and China. However, when analyzing per capita GDP, the story is a bit different. The **International Monetary Fund (IMF)** sets U.S. per capita GDP as \$54,600 and EU at \$35,600, while China’s per capita GDP stands somewhere between \$7,500 and \$12,800. The countries that make up the **Eurozone** have a per capita GDP of \$35,900. Individual countries of the EU have some of the world’s highest per capita GDPs including Austria at \$46,400, Germany at \$46,000, Denmark at \$44,400, France at \$40,400, and the United Kingdom at \$39,500. National per capita GDPs vary widely across the EU from Ireland and Netherlands at \$49,200 and \$47,400 to Bulgaria at \$17,900 and Romania at \$19,700.

Gross Domestic Product (GDP): GDP is the value of all goods and services produced in a country. GDP is used to measure economic output. The growth rate in GDP is closely monitored by central banks, such as the U.S. Federal Reserve, to determine whether the economy is growing too quickly or slowly. Recessions are defined as two consecutive quarters of contracted or negative GDP. This assessment guides the banks in setting monetary policy. **Per Capita GDP** is a country’s GDP divided by the population of the country. For economic information on any country, see www.worldbank.org/en/country.

Despite the great disparity of wealth across the EU, as a single entity it has become a major economic power.

The Treaty of Rome established the “**Four Freedoms**,” which continue to guide the EU to the present: (a) free movement of goods, (b) free movement of persons, (c) free movement of services, and (d) free movement of capital. Along with the “Four Freedoms,” the general principles of the EU include: (1) fundamental human rights, (2) subsidiarity, (3) proportionality, (4) legitimate expectations, (5) nondiscrimination, and (6) legality and legal certainty. The first three principles will be discussed in-depth later in this chapter. For an introduction to these principles see Figure 8.2: “Summary of EU Principles”. The *principle of legitimate expectations* prohibits the adoption of retroactive laws, which in the U.S. Constitution is called the prohibition against *ex post facto* laws. The **principle of nondiscrimination** refers to the preservation of civil rights. Article 13 of the Treaty of Amsterdam empowers the **EU Council** to take appropriate action to combat discrimination based on sex, racial or ethnic origin, religion or belief, disability, age, or *sexual orientation*. Council Directive 76/207, the Equal Treatment Directive, mandates member states to implement into their national laws the principle of equal treatment of men and women in employment.



Figure 8.1 Map of the European Union.

Source: Hayden120, Wikimedia Commons.

The **European Court of Justice (ECJ)** recognized the *principle of legality and legal certainty*¹ in the case of *Leden van de Ministerraad*.² The Court examined whether a European arrest warrant violated the principle of legality. The Court states that: “this principle implies that legislation must define clearly offences and the penalties.” That condition is met when individuals are able to determine which types of acts or conduct make them criminally liable. The Court rejected challenges to the European arrest warrant based on legality.

In *Jungnunzlauer v. Commission*,³ a company was fined for a violation of **competition law**. The **EU Commission** has the power to impose fines of up to 10 percent of a company’s preceding year’s gross revenues for a violation of competition law. The company argued that the law violated the principle of legality because it did not adequately specify the penalties for violations of competition law. The Court ruled that the principle of legality is a corollary of the general principle of legal certainty, which required that civil and criminal penalties be sufficiently precise. However, it ruled against the company and found the law to be adequately precise. It should be noted that the standard isn’t simply whether an ordinary person would be able to understand the law. The standard is whether a person “with the assistance of counsel” would be able to understand the law and its consequences.

<p><i>Four Freedoms</i></p> <p>The goal of the EU is to ensure the free movement of persons, goods, services, and capital.</p>	<p><i>Legitimate Expectations</i></p> <p>A new law cannot punish past conduct. The law prohibits the adoption of retroactive laws.</p>
<p><i>Subsidiarity</i></p> <p>EU shall act only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the member States.</p>	<p><i>Non-discrimination</i></p> <p>Member states shall not arbitrarily discriminate against individuals on the basis of characteristics that are not relevant to their abilities.</p>
<p><i>Proportionality</i></p> <p>The EU law may not exceed what is necessary to achieve the legitimate objectives of the EU.</p>	<p><i>Legality and Legal Certainty</i></p> <p>Laws must be clear, transparent, and subject to interpretation by a reasonable person with the help of legal counsel.</p>

Figure 8.2 Summary of EU Principles.

The numerous benefits of EU membership affect both the individual directly and also through benefits that adhere to the member countries. First, individuals have the ability to move freely throughout the EU. When on vacation, individuals have easy access to medical care through a European Health Insurance Card. Most EU and some non-EU countries have signed the Schengen Agreement, which creates a border-free area that allows people to travel from country to country. Second, the single currency allows consumers and companies to directly compare the prices of items or services across countries and save the costs of exchanging money from one currency to another. Third, along with the benefits of a single currency, consumers are benefited by cheaper mobile phone and SMS rates, cheaper air fares within the EU, stronger passenger rights, and higher quality standards, such as the “CE” certification and marking of goods. Fourth, there is greater economic and social cohesion resulting from the creation of the Regional Development Fund (infrastructure and job creation) and the European Social Fund (training for the unemployed and disadvantaged). However, the freedom to immigrate to other countries has been destructive to some countries, such as Bulgaria, which lost between 15–20 percent of its population after entering the EU, and has caused ethnic-racial strife, and increasing xenophobia, in countries such as the United Kingdom. Fifth, the EU has raised environmental and food standards including clearer food labeling and stricter standards for waste management and the use of chemicals.

Evolution of the European Union

The establishment of the EU is the culmination of a lengthy historical process started at the end of World War II. The EU was constructed through a series of Treaties beginning with the 1952 **Treaty of Paris**, which created the European Coal and Steel Community (ECSC). The next major step was the creation of the common market with the establishment of the European Economic Community (EEC) by the **Treaty of Rome** (renamed the Treaty on the Functioning of the European Union or TFEU) in 1957. The original members of the EEC were Belgium, France, Italy, Luxembourg, Netherlands, and West Germany (Denmark, Ireland and the United Kingdom joined in 1973). As noted above, the Treaty of Rome established the four freedoms needed to construct a common market (free movement of goods, persons, services, and capital). The 1992 **Maastricht Treaty** (officially “Treaty of the European Union” or TEU) began the process of transforming the economic union into a political union with the creation of the European Community (EC). The EC’s purpose was not only to protect the common market, but also to facilitate cooperation of the police and judiciaries in criminal matters and to develop a common foreign and security policy.

The 1997 Treaty of Amsterdam adopted the **Schengen Agreement**, which abolished physical borders between EU countries and allows for passport-free travel throughout the EU except for Ireland and the United Kingdom.

Table 8.1 EU Countries

Country	Year of Entry	Votes (Parliament)	Population (millions)	2014 GDP (billions) (Euros)
Austria	1995	18	8.5	313
Belgium	1958	21	11.2	383
Bulgaria	2007	17	7.2	40
Croatia	2013	11	4.2	43
Cyprus	2004	6	.85	16.5
Czech Republic	2004	21	10.5	149.4
Denmark	1973	13	5.6	250
Estonia	2004	6	1.3	18.6
Finland	1995	13	5.5	194
France	1958	74	66	2,100
Germany	1958	96	81	2,800
Greece	1981	21	11	182
Hungary	2004	21	9.9	98
Ireland	1973	11	4.6	164
Italy	1958	73	61	1,600
Latvia	2004	8	2	23.5
Lithuania	2004	11	2.9	35
Luxembourg	1958	6	.55	46
Malta	2004	6	.425	7.3
Netherlands	1958	26	16.8	603
Poland	2004	51	38.5	390
Portugal	1986	21	10.4	166
Romania	2007	32	19.9	142
Slovakia	2004	13	5.4	72
Slovenia	2004	8	2.1	35
Spain	1986	54	46.5	1,023
Sweden	1995	20	9.6	421
United Kingdom	1973	73	64.3	2,000
Total	28 countries	751	507 million	12.7 trillion Euro or 16.8 trillion USD

Three non-EU countries also signed the Schengen Agreement—Iceland, Norway, and Switzerland. The **Lisbon Treaty** of 2009 created a political union (government) known as the European Union.

Germany and France have been the driving force behind the idea of the EU, with the third major power, the United Kingdom, being a reluctant partner. The UK is reconsidering its membership in the EU. Table 8.1 lists the member states of the EU, the year of their entry into the EU or to one of its predecessor organizations, seats in the **EU Parliament**, population, and GDP. Candidate countries on the “road” to membership include: Albania, Iceland, Montenegro, Serbia, Former Yugoslav Republic of Macedonia, and Turkey. Applications have been submitted for membership by Albania and Serbia, but entry is not expected in the near future. To become a member a country must respect democracy, have a functioning market economy, a civil servant system, and agree to accept all of the laws of the EU (*acquis communautaire*).

Acquis Communautaire (*acquis* meaning “that which has been agreed upon”; *communautaire* meaning “community”): The *acquis* refers to all the rights and obligation of the members of the EU. It refers to the entire body of law generated by the EU or relating to the EU (Treaties, Directives, Regulations, Policies, and Decisions of the EU Court of Justice). Before entering the EU, a candidate country must agree to make the *acquis* a part of its national law.

Norway is not a member of the EU, neither is Iceland or Switzerland, but these countries have entered, along with Liechtenstein, into free trade agreements (FTAs) with the EU.

Treaty of Lisbon

The Treaty of Lisbon is the most significant current document because it transforms an economic and quasi-political union (EC) to a full-fledged political union with its own independent government structure. The Treaty of Lisbon established the Council President as the leader of the EU and made the EU lawmaking process more efficient by doing away with unanimous voting in most areas of EU governance. The ordinary scheme for the EU Council to approve new laws now only requires what is referred to as **double majority voting** (EU Council majority of 55 percent of member states and enough member states that represent 65 percent of the EU's population). This move away from requiring unanimous voting has made the EU a more workable democracy. At the same time, the Treaty of Lisbon recognized the importance of the sovereignty of individual member countries by establishing a consultation mechanism between the EU lawmaking institutions and national parliaments. Proposed new laws now have to be submitted to national parliaments for review and the national parliaments have the right to raise objections to the EU draft legislation. See Figure 8.3: "Treaty of Lisbon."

The main purpose of the Treaty was to introduce a series of reforms relating to the EU's powers and limitations. It also made the **Charter of Fundamental Rights** part of EU law. The major "Articles" of the treaty include:

Article 2, EU Values: The EU is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail.

Article 3, Free Movement of Persons: The EU shall offer its citizens an area of freedom, security and justice without internal frontiers, in which the free movement of persons is ensured in conjunction with appropriate measures with respect to external border controls, asylum, immigration and the prevention and combating of crime.

Article 5, EU Enumerated Powers (Competencies): Under the principle of conferral, the EU shall act only within the limits of the competencies conferred upon it by the Member States in the Treaties to attain the objectives set out therein. Competencies not conferred upon the EU in the Treaties remain with the Member States.

These three articles reaffirm three crucial tenets of the EU. Article 2 essentially reiterates the rights provided under the Charter of Fundamental Rights as core (constitutional) values of the EU. It is similar to the function played by the American Bill of Rights. Article 3 singles out the free movement of persons as the core principle of a political union. Article 5 makes clear that the individual countries retain sovereignty over all areas of law not expressly delegated by the Treaties to the EU. This is a much stronger version of what is referred to as the "states' rights doctrine" under the U.S. Constitution.

Created the "President of the European Council"
Expanded Co-decision to require approval of the Council and Parliament to enact new laws
Eliminated many areas that required unanimous approval of the Council and extended the use of "Qualified Majority Voting"
Established EU as a single political entity

Made the "Charter of Fundamental Rights" legally binding
Retained the principle of one Commissioner per country
Gave national parliaments additional input into EU decision-making

Figure 8.3 Treaty of Lisbon.
(January 21, 2009).

EU Institutions

There are four major institutions that make up the EU government: Council, Commission, Parliament, and EU Court of Justice (ECJ). See Figure 8.4: “EU Institutions” and see Figure 8.5: “EU Government and Political System.” The EU Council sets the broad political guidelines for the Union. While the work of the Council is ongoing, the Heads of State of the member countries meet as the Council, together with the President of the Commission, four times a year. The Commission is the body of appointed bureaucrats that manage the day-to-day running of EU agencies, draft new laws, and has a duty of loyalty to the EU as a whole. The Parliament is one of the two lawmaking bodies, along with the Council, and is directly elected by the European people. The ECJ is the EU’s “supreme court” that is viewed as the protector of EU Treaties by ensuring the proper interpretation and implementation of EU law.

Council of the European Union

The **Council of the EU**, also known as the *Council of Ministers* or *Council*, serves as the voice of the member countries, depending on the topic. The ministers that make up the Council depend upon the subject being discussed. For example, if the issue relates to finance, the Council would consist of the 28 Finance Ministers of their respective countries.

The Council has five main roles: (1) pass laws in conjunction with the Parliament, (2) set EU economic policy, (3) implement security and foreign relations policy, (4) coordinate police and judicial matters, and (5) pass a budget with the Parliament. Laws are discussed and drafted by a professional staff. First, “Working Groups” consisting of national legal experts examine policy proposals. Their work is then sent to the **Committee of Permanent Representatives** (*Comité des Représentants*) or **Coreper**, which is made up of diplomats from each member country. Finally, proposals are sent to the Council for consideration. The Council is headed by a rotating President who serves for six months with a representative of each member country taking its turn. When the heads (presidents or prime ministers) of each country meet, the group is referred to as the **European Council**, which is the highest political body in the EU. The European Council meets in Brussels four times a year. It does not pass any laws, but it sets the political direction and priorities of the EU.



Figure 8.4 EU Institutions.

The Council represents the individual countries in the decision and lawmaking process and is the strongest power on most issues, acting at times as an executive branch of government. In contrast, the members of the EU Parliament are directly elected by the people and primarily represent their individual constituencies. The Commission's focus and loyalty is to the EU as a whole. A few areas, such as defense and taxation, still require unanimous votes. An example is the sanctions placed against Russia for its invasion and annexation of Crimea in 2014 and its intervention in support of rebels in eastern Ukraine required unanimous votes.

Which Council?

Council of the European Union

It is one of the three main EU Institutions, along with the Commission and the Parliament. It is made up of government ministers from each of the member countries. It has permanent headquarters in Brussels.

The European Council

It is the highest political body of the EU made up of the heads of each of the countries. It meets only four times a year.

Council of Europe

It is an international organization of 47 European countries that is NOT a part of the EU. It was established in 1949 and has headquarters in Strasbourg (France). Its objective is to foster common and democratic principles for all of Europe

EU Commission

The EU Commission is headed by 28 commissioners, one each appointed by a member country. The Commission is the bureaucratic institution staffed by about 5,000 civil servants. The Commission researches, drafts, and proposes laws to be considered by the Council and Parliament. The EU Commission is located in Brussels, Belgium and Luxembourg. The Commission is composed of departments called **Directorate Generals (DG)**, which are responsible for different areas of government. The analogy to the U.S. Government would be Cabinet Departments, such as the Departments of the Treasury, Commerce, Defense, Transportation, and so forth, each headed by a Secretary, such as the Secretary of State. For example, Directorate IV is assigned the area of monitoring competition (antitrust) law. Thus, if a foreign company wants to merge or acquire a company located in the EU, it will have to obtain the approval of this Directorate if the combined market share of the two companies is above a certain percentage. Other important DGs for foreign companies doing business in the EU include: Trade; Taxation and Customs Union; Mobility and Transport; Health and Consumers; Environment; and Employment, Social Affairs, and Inclusion.

The Commission is also the manager of the EU budget and acts as the external representative of the EU. The Commission is an independent body appointed by the member states to act as the neutral guardian of their shared interests and to promote the general interest of the Union. It monitors the implementation of EU law, proposes legislation, and has important executive functions. Commissioners are nominated by member states, approved by the European Parliament, and are appointed for a period of five years.

EU Parliament

The Parliament is the only directly elected institution of the EU. There are 751 Members of the European Parliament (MEPS) that are elected, all at the same time, for terms of five years with the next elections in 2019 and 2024. They meet at different times in Brussels, Luxembourg, and Strasbourg, France. Its administrative staff is located in the General Secretariat. The Parliament acts as a co-legislator with the Council through a process called co-decision. The Parliament also has the power to approve the budget.

The Treaty of Lisbon greatly expanded the number of areas in which the Parliament is co-legislator with the Council, through the so-called co-decision or "ordinary legislative procedure." Under co-decision, EU measures

have to be agreed to by both the Council of Ministers (representing the governments of the member countries) and by the (directly-elected) Parliament. Co-decision will be discussed below in the section on “EU Lawmaking.” The increase in the power of Parliament represents a significant strengthening of democratic accountability within the EU. The double majority or qualified majority voting (55 percent of the member states comprising at least 65 percent of the population) that applies to the Council also applies to the Parliament.

European Court of Justice

The Court of Justice or *Cour de Justice de l'Union Européenne* (ECJ) is charged with interpretation and application of the EU's treaties, as agreed by the member states, and the laws made under those treaties by the EU's institutions, ensuring that they do not overstep the bounds of the competencies conferred on them by the member states. The ECJ is the highest judicial authority in the EU. Its jurisdiction includes examining the legality of EU laws and measures, and its interpretations of EU law are final. The Treaty of Lisbon established a lower court called the General Court (previously known as the Court of First Instance) to take some of the workload off the ECJ. Decisions of the General Court are appealable to the ECJ.

It should be noted that the **European Court of Human Rights (ECtHR)** is not an EU court. It is an international court established by the Council of Europe's **European Convention on Human Rights (ECHR)**. There are 47 member countries of the Council of Europe, EU and non-EU countries, almost all of which have adopted the ECHR. The only exceptions are Belarus, Kazakhstan, and Vatican City. The non-EU countries that have adopted the ECHR include Russia, Turkey, and Ukraine.

Jurisdiction of the European Court of Justice

The ECJ has a number of areas of jurisdiction, including: (1) cases brought by EU institutions against member states not complying or implementing EU law, (2) cases brought by member states or individuals against EU institutions for overstepping their enumerated powers (competencies), (3) cases brought by individuals against a member state for not properly implementing EU law, (4) cases brought by one member state against another member state, (5) cases appealed from the General Court, and (6) referrals from national courts for an opinion on the meaning of EU law. The first five bases for jurisdiction are *direct actions* brought to the ECJ. Under the first category of jurisdiction, the Court may declare that a member state had failed to fulfill its obligations under EU law and can impose monetary penalties against the violating country. Under the second category, the Court may void a law enacted by the EU or actions taken by the Commission. Under the third category, an individual, group, or association may bring suit against a country that has improperly implemented an EU Directive. Under the fourth category, one member state may bring an action against another member state for violating EU law. Under the fifth category, the Court has appellate jurisdiction over actions commenced in the Court of First Instance. That is, a party dissatisfied with a ruling of the Court of First Instance can, in appropriate circumstances, appeal to the ECJ. The jurisdiction of the Court of First Instance is broad since it is allowed to hear cases brought by individuals, member states, and the EU Commission, as well as cases involving competition (antitrust) law. It may also hear cases for preliminary rulings brought by courts of the member states. However, the Court of First Instance has the power to refer the request for a preliminary ruling to the Court of Justice.

Under the last category of jurisdiction, the ECJ issues rulings and opinions on the meaning of EU law in cases referred to the ECJ from courts or tribunals of member countries.⁴ However, the ECJ's reply is not merely an opinion but takes the form of a judgment or a reasoned order. The national court to which it is addressed is bound by the interpretation given. The Court's judgment also binds other national courts before which a problem of the same nature is raised. The rationale for this procedure is to ensure the uniform application of EU law by avoiding divergent national court interpretations. The referral to the ECJ generally occurs during the trial of an actual case. The referral suspends the court proceeding until the ECJ or General Court replies. In the *Flaminio Costa* case that follows, the ECJ reaffirmed the *principle of supremacy* of EU law and the right of national courts to seek opinions of the ECJ on issues relating to EU law.

Flaminio Costa v E.N.E.L.

Judgment of the European Court of Justice (July 15, 1964)

This case is brought before the European Court of Justice (ECJ) on referral from the *Giudice Conciliatore* in Milan having regard to Article 177 of the Treaty establishing the European Economic Community (EEC) and subsequently incorporated into Italian Law. The lower court seeks a preliminary ruling interpreting the Treaty. The Italian Government contests the jurisdiction of the ECJ to provide such a ruling involving a national court applying national law.

Facts

Mr. Costa was an Italian citizen who had owned shares in an electricity company and opposed the nationalization of the electricity industry in Italy. He refused to pay his electricity bill in protest and was sued for nonpayment by the newly created state electricity company. In his defense he argued that the nationalization of the electricity industry violated the Treaty of Rome and the Italian Constitution. The Italian judge, the *Giudice Conciliatore of Milan*, referred the case first to the ECJ.

The Italian Constitutional Court gave judgement in March 1964, ruling that while the Italian Constitution allowed for the limitation of sovereignty for international organizations, like the EU, it did not upset the normal rule of statutory interpretation under the principle *leges posteriores priores contrarias abrogant*, which means that a subsequent statute (nationalization of the Italian electricity industry) prevails over an earlier one (Treaty of Rome) in cases where they are in conflict. The Treaty of Rome was enacted into Italian law in 1958, while the nationalization laws were enacted in 1962. The Italian government asserted that since the lower court in Milan had to abide by the ruling of the Constitutional Court and could not set aside a national law, the petitioning of the ECJ for a ruling served no legal purpose.

On the question of the invalidity of referring an issue to the ECJ for an interpretation, the ECJ ruled against the Italian Government. It held that the Treaty was an independent and special source of law that could not be overridden by domestic law.

Ruling

By contrast with ordinary international treaties, the EEC Treaty created its own legal system, which became an integral part of the legal systems of the member states and which their courts are bound to apply. As a subsequent unilateral measure cannot take precedence over community law, the questions put by *Giudice Conciliatore of Milan* are admissible in so far as they relate in this case to the interpretation of provisions of the EEC Treaty. This case is additional confirmation that under Article 267 of the Treaty on the Functioning of the EU, a court has an obligation to refer cases that have reached the highest point of appeal in their respective country, if there is a question on the application of EU Law. Costa had reached its highest point of appeal.

Case Highlights

- The **principle of supremacy** holds that when a national law conflicts with an EU law the EU law controls. In U.S. constitutional law this is known as the “doctrine of preemption.” A subsequent national law that conflicts with EU law is *void ab initio* (from the very beginning).
- National courts have the right to seek an opinion of the ECJ on matters of EU law.
- A court of highest appeal must seek the opinion of the ECJ if it is unclear on a matter of EU law.

European Central Bank

The **European Central Bank (ECB)** was founded June 30, 1988 and is located in Frankfurt, Germany. It is the central bank for the euro and is responsible for the monetary policy of the Eurozone. Its main responsibility is to maintain financial and price stability in the Eurozone (countries that use the euro as their national currency). The ECB is “owned” by the central banks of all the EU member countries. The ECB, much like the U.S. Federal Reserve, is independent of the other institutions of the EU. It is one of the seven institutions of the EU, along with the European Council, Council of the European Union, Commission, Parliament, ECJ, and the Court of Auditors, which is similar to the U.S. Congressional Budget Office (see Figure 8.5).

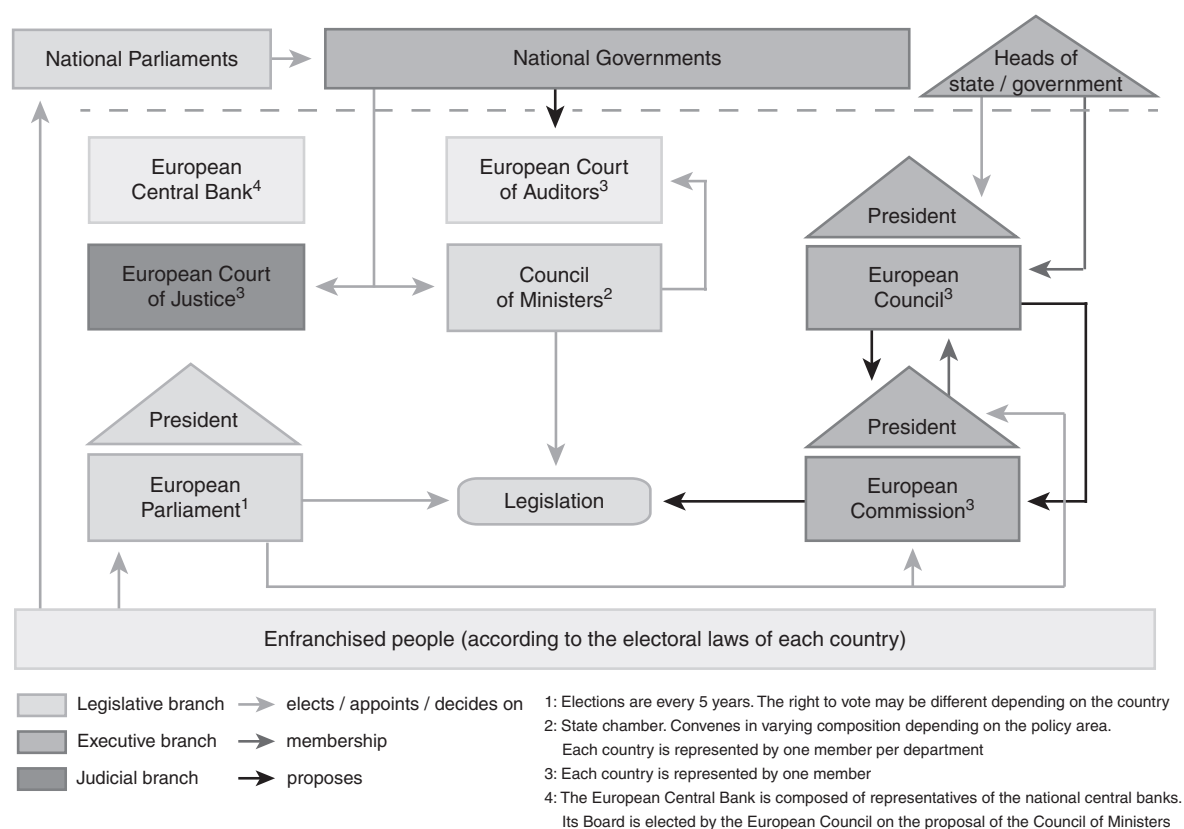


Figure 8.5 EU Government and Political System.

Source: 111Alleskönner, WikiCommons.

Prior to the 2008 financial and sovereign debt crises, the ECB rarely interceded in a meaningful way to impact the monetary policies of member states. The debt crises, beginning in 2010, required the EU and the IMF to bail out Cyprus, Greece, Ireland, and Portugal. In 2014, Ireland and Portugal exited their bailout programs successfully, but the crisis continued to get worse in Greece, forcing the ECB to exercise its powers to help save the euro. On June 30, 2015, due to a delay in making the required reforms and a worsened economic recession, Greece became the first developed country to default on its IMF debt. This crisis threatened the economic collapse of Greece and its possible expulsion from the Eurozone. No country has ever been forced to exit the Eurozone.

Sovereign Debt Crisis refers to the situation when a country can no longer or will no longer make required debt payments on loans and government bonds. In such cases, the International Monetary Fund (IMF), along with the ECB in the case of the Eurozone, lend money to the potentially defaulting country in exchange for structural reforms aimed at cutting the country's debt load in the hope of increasing the country's ability to pay off its debts in the future.

EU Lawmaking Process

Like the U.S. Constitution, the EU is a government of enumerated powers known as the **principle of conferral**. The EU has no power to legislate in areas outside of its “competencies.” EU Treaties describe three types of EU **competencies**: (1) *exclusive competence*, including legislating in areas related to the regulation of the customs union; competition rules necessary for the internal market; monetary policy in the Eurozone; fisheries; and common commercial policy. (2) *Shared competence* recognizes that in some areas the EU and its member countries share power, such as in the areas of the internal market; social policy (mostly to do with employment rights); economic, social, and territorial cohesion; agriculture; the environment; consumer protection; transport; trans-European networks; energy; security and justice; and public health concerns. (3) *Supporting competence* is where the national countries have the primary power with the EU acting in a supporting or coordinating role. This area includes the protection and improvement of human health, industry, culture, tourism, education, youth, sport and vocational training, civil protection (natural disasters), and administrative cooperation between national authorities.

In areas that do not fall within the EU’s *exclusive* areas of competency, two principles control the extent of the EU’s lawmaking powers—the **principle of subsidiarity** and the **principle of proportionality**. Under the principle of subsidiarity, the EU shall act only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the member states, either at the regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at the EU level. In areas of shared competence, action may be taken by the EU only where such action is likely to be more effective than action taken at the national level. The EU may only act if objectives cannot be sufficiently achieved by the member states, either at national or local level, or where, because of scale, they can be better achieved at EU level.

At the same time, under the principle of proportionality, when the EU acts (legislates), it shall not exceed the scope of its competency. Under the principle of proportionality, action of the EU may not exceed what is necessary to achieve the objectives of the EU. Article 2 of the Treaty of Lisbon recognizes human dignity, minority rights, and equality as community values. The test of proportionality involves asking the following set of questions. First, are the interests that the administrative action seeks to promote legitimate? In other words, is a proper goal being pursued? Second, do the means chosen advance the goal that is being pursued? Third, are the means chosen the least restrictive available? Are these means proportionate to the goal? If the challenged measure fails one of these three tests, then it must be struck down.

The EU lawmaking process is characterized by two principles: **co-decision** and **qualified majority voting (QMV)**. These principles together make up the **Ordinary Legislative Procedure** by which most laws are adopted. Co-decision is the procedure through which the Council and the Parliament jointly enact most EU legislation. The co-decision principle requires approval of the Council and Parliament. It gives equal roles to the Council and the Parliament in the adoption of regulations, directives, and decisions. As noted earlier, QMV or *qualified (double) majority voting* requires that for a law to be approved by the Council it must receive the approval of 55 percent of the member countries, and the countries that approve must represent at least 65 percent of the EU population. The rationale behind double majority voting is that it gives proportionate weight to population and also gives an equal say to each member state. In the Parliament, each member state has a number of votes weighted according to their population sizes. For example, Germany has the most seats at 96, and Cyprus, Estonia, Luxembourg, and Malta have the minimal level of seats set at six. See Table 8.1 for the number of Parliamentary seats allocated to each country. A proposed law needs only a simple majority vote in the Parliament.

Prior to the Treaty of Lisbon, passage of laws in numerous areas required a unanimous vote of the Council including: energy, intellectual property, social security for migrant workers, judicial cooperation in criminal matters, the structure of Eurojust⁵ and Europol,⁶ urgent financial aid to third countries, and support measures in the field of culture. These areas now only require a double majority vote.

In some areas, the EU Treaties provide that the Ordinary Legislative Procedure is replaced by **Special Legislative Procedures**. For example, unanimity applies within the Council in certain areas, such as EU security and foreign policy. The Council may act alone, without consulting Parliament, in setting the EU’s common external tariff or in negotiation of free trade agreements.

Sources of EU Law

Community law can be divided into two parts—primary law and secondary law. The primary law comes from the fundamental law of the EU (treaties). Secondary sources of law consist of the types of legislation that can be enacted by EU institutions. The three types of laws that can be passed by the EU institutions are: (1) regulations; (2) directives; and (3) decisions, recommendations, and opinions. The major distinctions between these different sources of law are as follows.

A **regulation** has general application and is legally binding and directly applicable in all member states (**direct effect**). Since regulations have direct effect, they become the law of each member country and, therefore, do not need national implementing legislation as do directives.

A **directive** is legally binding but gives member states flexibility as to how the prescribed results are to be achieved. A directive leaves to member countries the choice of form and methods of implementation. Typically, a directive dictates an outcome or result and a deadline that member states are required to satisfy. The member states adopt a domestic law (or statutory instrument) in advance of the deadline enacting the directive into national law. However, nothing requires that member states meet their obligations through a word-by-word implementation of the language of the directive. The EU Commission may bring an enforcement action against a member state if it believes the state has not properly implemented the directive.

A *decision* is legally binding, but only on those to whom it is addressed. The EC often employs decisions in the area of competition law. In other words, if the Commission suspects that a violation of competition law has occurred, it may conduct an investigation and issue a decision finding a company or individual to have violated the law.

Recommendations and *opinions* have no binding force, but they may set out important EU policy positions. Recommendations are issued on the initiative of the Commission, while opinions are usually a response to a question posed by a member state. The Council, either acting jointly with Parliament or upon a recommendation from the Commission, has the choice as to which type of legal instrument to adopt.

EU Law and Direct Effect

EU Treaty Articles or provisions and regulations have a direct effect⁷ in each of the member states. The major case in this area is *Van Gend en Loos*.⁸ In that case, a lawsuit was filed in the Dutch court system. The main issue in the case was whether private parties could bring a lawsuit in a national court to enforce an EU treaty provision. The issue was referred to the ECJ, which considered the issue of the direct effect of Treaty Articles.

Van Gend en Loos

[1963] ECR I

The claimant asserted that the Netherlands had increased the import duty on a good from another member state in violation of EU law, which forbade increasing national duties.⁹ The Dutch argued that there was no increase of tariff rates but that the goods had simply been reclassified. The Dutch argued that the EU law did not prohibit the reclassification of goods. The issue was whether an individual could invoke a Treaty provision in a national court. Since the Dutch court was not sure of the answer, and

because a decision on the issue was central to deciding the case, the court referred the case to the ECJ.

The government of the Netherlands, joined by Belgium, argued that the ECJ lacked jurisdiction to consider the issue. They argued that the question of the relation between national and EU law was a national constitutional issue for the national courts to decide. However, the ECJ concluded that it had the right to interpret the provisions of all the relevant Treaty Articles. The issue was then whether the

Treaty provision relating to tariffs had direct effect and granted private citizens the right to sue.

ECJ Reasoning

The Court first applied a purposive or teleological approach to interpreting the Treaty. A narrower approach would have asked whether the particular Article expressly provided that individuals had standing to bring a lawsuit to enforce the Article. Instead, the Court took a more liberal approach by asking the hypothetical question of what was the purpose for the drafting of the Treaty Article

and whether granting a private standing to sue would support that purpose. The Court concluded that individuals could invoke Treaty Articles in national courts.

Case Highlights

- The ECJ is the highest authority in interpreting EU law.
- EU Treaties have direct effect (immediately becomes a part of national law).
- Private parties have standing to litigate violations of EU law in national courts.

However, in *Van Gend en Loos*, the Court did not confine itself to the likely intent of the founding member states. Instead, its focus was in promoting the purpose of the EU. The doctrine of direct effect and the *Van Gend en Loos* interpretation are an important part of EU law.¹⁰ It concluded that a Treaty Article was capable of producing direct effect, based on the “the spirit, the general scheme and the wording of the Treaty.” In effect, the ECJ treats all the EU Treaties as constitutional in nature. By doing so, the ECJ recognized the EC and then the EU as an independent legal entity.

The next foundational case that created the EU in its current form involved the awarding of damages against a county for not implementing EU directives. The *Francovich* case addressed this issue.

Francovich and Bonafaci v. Italy

[1991] ECR I-5357

The EU had adopted a directive, Directive 80/987, the purpose of which was to protect individuals who worked for companies that became insolvent. It did this by requiring member states to set up a fund from which employees who were owed money by employers could make a claim. Italy did not implement the Directive into national law before the expiration of the deadline for doing so. The Commission brought an enforcement action against Italy, and the Court ruled that Italy had violated its obligations under EU law by the failure to implement the Directive.

Two workers of a company that had become insolvent brought suit when they were unable to obtain compensation from the state because Italy had not implemented Directive 80/987 and set up a fund for compensation. They sought to invoke the terms of the Directive against Italy by arguing that directives have vertical (direct) effect. The ECJ, in *Van Gend en Loos*, outlined the conditions for a law to have a direct effect. First, the EU law must: (1) be clear and unambiguous, (2) be unconditional, and (3) not depend upon further legislative measures. Directives are dependent on

further national legislation for implementation and, therefore, do not have direct effect.

The Court concluded that Directive 80/987 lacked direct effect either because it was not sufficiently precise or because it required further implementing measures in the form of setting up the fund from which individuals were to be compensated. Therefore, the parties could not rely upon the Directive in filing suit against Italy. The Court went on further to consider whether a member state could, nonetheless, be made to pay damages for failure to implement a directive.

The Court reasoned that a member state could be liable in damages for failure to implement a directive based on “the general scheme and basic principles of the Treaty”:

The full effectiveness of EU provisions would be affected and the protection of the rights they recognize undermined if individuals were not able to recover damages when their rights were infringed by a breach of EU law attributable to a Member state. The obligation on member states

to make good the damage is also based on Article 10 of the Treaty, under which the member states are bound to take all appropriate measures, whether general or particular, to ensure fulfillment of the obligations arising under EU law. This includes the obligation to make good the unlawful consequences of a breach of EU law.

Three conditions must be satisfied to extend such liability. First, the Directive must confer rights on individuals; second, it must be possible to determine the rights conferred by reference to the Directive; and third, there must be a causal relationship between the failure to implement the Directive and the damages suffered. The Court holds that the claimants met all three of the conditions for liability. The Directive conferred rights on

people like the claimants, it was possible to determine those rights by looking at the Directive, and the damages resulted from failure to implement the Directive.

Case Highlights

- According to the conditions laid down in *Van Gend en Loos*, EU directives do not have direct effect in that they do not immediately become the law of member countries.
- *Francovich* lays down three conditions for holding a member country liable to private parties for failing to implement an EU directive.
- By allowing parties to sue when a directive is not implemented (or not implemented properly), the Court in *Francovich* minimized the lack of the fact that directives do not have direct effect.

Four Freedoms

The “Four Freedoms” are the **free movement of goods, free movement of persons, free movement of services, and free movement of capital**. The free movement of goods within the EU is of critical importance to foreign exporters. An American exporter only needs to import and clear customs in one of the 28 EU countries. After the initial importation, the goods can be freely distributed throughout the EU.

Free Movement of Goods

Member states continue to try to protect local goods and prevent the importation of competing goods from other member states. One method is to impose a higher internal tax on the imported goods than on a similar, domestically produced goods. EU law makes such discriminatory taxation illegal. Article 90 of the TEU states: “No Member State shall impose, directly or indirectly, on the products of other member states any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products.”

Furthermore, no member state can impose on the products of other member states any internal taxation of such a nature as to afford *indirect* protection to other products. First, there is a prohibition on customs duties on imports and exports between member states, as well as a prohibition on charges that have the same effect as such duties.¹¹ Second, there is a prohibition against quantitative restrictions (quotas) on imports and exports between member states.¹²

In the *Cassis de Dijon* case,¹³ an importer of liqueur from France to Germany challenged a German law that prohibited importation of certain alcoholic drinks if they did *not* have a high enough alcohol content. The importer argued that the minimum level of alcohol requirement violated the guarantee of free movement of goods. The Germans sought to defend the German rule on the basis that it was necessary to fight alcoholism. They claimed that drinks with a low alcoholic content encouraged people to drink more and to become alcoholic. [*Can you believe this argument?*]

The Court rejected the German argument based on proportionality criteria.¹⁴ In other words, discouraging alcoholism is a legitimate goal, so the first requirement of proportionality is met. However, the means chosen did not rationally advance that legitimate goal. The Court reasoned that people often dilute stronger liquor before drinking, so prohibiting the importation of low alcoholic content drinks has no rational connection to fighting

alcoholism. Instead, the rule was a *disguised* protection favoring German manufacturers of liqueurs, who made their liqueurs with a stronger alcohol content.

Indirect Discrimination

Indirect discrimination includes systems of taxation that make no express reference to the origin of goods, but in practice results in higher tax rates for imported goods. In *Humblot v. Directeur des Services Fiscaux*,¹⁵ a French citizen claimed a refund for a French road tax he was required to pay on a Mercedes purchased in France. The French tax scheme increased the amount of road tax owed based on the car's horsepower. The amount of tax increased gradually up to a maximum of 1,100 French francs for a car with an engine rating of 16-CV. However, above 16-CV, the amount of tax suddenly increases to a flat rate of 5,000 French francs, which represented a 400 percent increase.

The road tax law makes no reference to the country of origin of the car, so, on its face, it did not expressly (directly) discriminate against imported cars. The claimant provided evidence that French automobile manufacturers did not produce cars with engines rated above 16-CV. Therefore, the higher rate of tax fell exclusively on imported cars, including cars imported from other member states.¹⁶ This is a classic example of indirect discrimination in that the law as written seems neutral, but the tax has a disproportionate negative impact on imported cars. The Court concluded that Article 90 of the TEU prohibits the charging of a progressive tax payable on cars, where the only cars subject to the special tax include those imported from other member states.

A final issue relating to the indirect discrimination of goods is the determination of the similarity of the imported goods with domestic goods. Article 90(1) prohibits discriminatory taxation between domestic goods and goods imported from other member states if those goods are "similar." There can only be discrimination if imported goods are discriminated against in relationship to similar domestic goods. The question is how do national customs officials and courts determine if goods are similar? Factors used in making the similarity determination include if the goods fall within the same tax category, how the goods were manufactured, the substances used in their manufacture, and whether consumers would regard the goods as substitutes.

Quantitative Restrictions and Measures Equivalent to Quantitative Restrictions (MEQRs)

Article 28 of the Treaty of Rome provides that: "Quantitative restrictions on imports and all measures having equivalent effect shall be prohibited between member states." Equivalent effect means that the restriction does not expressly limit the amount of goods being imported, as in a quota system, but the restriction has the equivalent effect of a quota in illegally limiting the amount of goods being imported. The ECJ has given a broad definition as to what constitutes a **measure equivalent to a quantitative restriction (MEQR)**, and that includes commercial rules and regulations that seemingly have nothing to do with imported goods, including opening hours for stores.

DEFINING MEQR

In *Procureur du Roi v. Dassonville*,¹⁷ Belgian law required that the importation of Scotch whisky needed to be accompanied by a certificate authenticating that the whisky was produced in Scotland. At the same time, Belgian distributors were importing Scotch whisky from France without a certificate of authenticity. The Belgian court referred the matter to the ECJ on the issue of whether the certification requirement was a MEQR. The ECJ broadly construed the concept of MEQR as "*all* trading rules enacted by Member states, which are capable of hindering, directly or indirectly, actually or potentially, intra-Community (EU) trade." They held that the certification requirement required for whisky imported from the United Kingdom was an illegal MEQR.

Exceptions to Quantitative Restrictions and MEQRs

Article 30 of the Treaty of Rome allows member states to restrict imports for the following reasons: (1) public morality; (2) public policy or public security; (3) protection of health and life of humans, animals, or plants; (4) protection of national treasures possessing artistic, historic, or archaeological value; or (5) protection of industrial or commercial property. The ECJ has narrowly construed these exceptions for fear that they could be used as disguised trade barriers.

PUBLIC MORALITY

In *R. v. Henn and Darby*,¹⁸ the defendants were convicted for importing obscene material into the United Kingdom in violation of its customs laws. The ECJ concluded that ordinarily there would be no problem with such laws against violations of public morality. The issue was whether the restrictions served that purpose in a non-discriminatory manner. The Court reasoned that: “If such materials could be freely manufactured or sold domestically, then the quantitative restriction contained in the customs law would be seen not as a means of protecting morality, but rather as a means of arbitrary discrimination or a disguised restriction on trade between member states.” The Court held that even though such materials were available domestically, they were not legally available. Therefore, the quantitative restriction on such imports was justified under the **public morality clause**.

PUBLIC POLICY AND PUBLIC SECURITY

In the past, certain types of products have been considered necessary for national defense. The beginning of the EU is anchored in this idea. The ECSC was established in 1952 in the aftermath of two World Wars. Coal and steel were the two main ingredients in the production of armaments. So the thought behind the ECSC was, if coal and steel production were regulated, it would lessen the possibility of another war. In *Campus Oil v. Minister for Industry and Energy*,¹⁹ an Irish law mandated that importers of oil had to purchase a proportion of their oil requirements from a refinery located in Ireland. Ireland argued that national security required that the country have at least one oil refinery. The ECJ agreed that this requirement served the purpose of national security.

PROTECTION OF HEALTH AND LIFE OF HUMANS, ANIMALS, AND PLANTS

In the area of health and safety inspection requirements for imported goods, the ECJ has shown a particular disdain for dual inspection requirements that require inspections in the exporting country and again when the goods are imported. The UK, in *Commission v. United Kingdom*,²⁰ placed a ban on poultry meat and eggs from other member states in order to prevent the spread of a disease affecting poultry (Newcastle disease). The EU Commission brought suit against the United Kingdom at the ECJ. The Court found that the UK ban violated EU law. The factors that were weighed by the Court included the unusual timing of the ban (Christmas season, when there is a major increase in the amount of eggs being imported) and that importation was allowed, but only if the exporting countries instituted stronger protective measures against the disease than those required of UK farmers.

CUSTOMS DUTIES AND CHARGES HAVING AN EQUIVALENT EFFECT

Article 25 of the Treaty of Rome states that the EU is based upon “a customs union which shall cover all trade in goods” and which prohibits the charging of customs duties or “charges having an equivalent effect” on imports and exports from member states, and the establishment of a “common customs tariff” between the EU and non-EU countries. Importantly for exporters from non-EU countries, Article 25 also states that no additional duties can be assessed at the national level to products originating “from third countries, which are in free circulation in member states.” As noted previously, for a foreign exporter this means that it only has to pay the common EU duty at the first

EU country of importation. The exporter is then free to move the goods throughout the EU without the need to pay any national duties.

CHARGES EQUIVALENT TO DUTIES

Just as the ECJ has a broad definition as to what constitutes a MEQR, it has broadly defined what constitutes a charge having an effect that is equivalent to a customs duty.²¹ In *Commission v. Italy*,²² the EU Commission alleged that Italy had violated EU law because it imposed a charge on all exports. Italy argued that the charge was not a customs duty but a payment for the compiling of statistical information, which was of benefit to exporters. The Court rejected this argument and held that:

Any pecuniary (monetary) charge, however small and whatever its designation and mode of application, which is imposed unilaterally on domestic or foreign goods by reason of the fact that they cross a border, and which is not a customs duty in the strict sense, constitutes a *charge having equivalent effect* within the meaning of the Treaty, even if it is not imposed for the benefit of the state, is not discriminatory or protective in effect and if the product on which the charge is imposed is not in competition with any domestic product.

Thus, the ECJ in *Commission v. Italy* adopts a per se rule relating to charges imposed on imported or exported goods. The purpose of the charge is not important. If the charge applies only to imported and exported goods then it is illegal.

In the areas of government charges imposed to inspect goods or the costs of obtaining the required inspection, the ECJ has held that if the inspection is deemed necessary for health or safety reasons, then charges related to the inspection are permitted. This is only in the case when the inspection is imposed on an importer as part of a general scheme of regulation that applies equally to domestic producers. In such cases, the charge is not equivalent to a customs duty.

Free Movement of Persons (Citizens and Workers)

Article 39 of the Treaty, as supplemented by Regulation 1612/68 and Directive 2004/38, prohibits both direct and indirect discrimination on grounds of nationality in the context of foreign workers. Treaty Article 39(2) states that the free movement of workers “shall entail the abolition of any discrimination based on nationality between workers of the Member states as regards employment, remuneration and other conditions of work and employment.” EU Regulations and Directives provide more specifics relating to “discrimination based on nationality.” Article 7(2) of Regulation 1612/68 provides that an EU worker shall enjoy the same “social and tax advantages” as national workers. Directive 2004/38 provides that EU citizens must be given at least three months to register in a foreign country in which they have resided for three months.

There are exceptions to the freedom of movement based on grounds of “public policy, public security or public health.” There have been some interesting cases in this area. The ECJ upheld a UK decision to deny entry to an EU citizen who practiced Scientology.²³ The UK justified the refusal because it believed that Scientology was anti-social and harmful and, therefore, against public policy. In *Adoui and Cornuaille v. Belgian State*,²⁴ two French nationals were denied residence permits by Belgium on grounds of public policy, since the women were alleged to be working as prostitutes. The ECJ ruled against Belgium since prostitution was not illegal in Belgium. Therefore, the women’s conduct, even if true, could not be regarded as sufficiently serious to justify deportation.

Free Movement of Services and Establishment

Free movement of services and establishment refers to the ability of nationals from one EU country to provide services or establish a business in other EU countries. Most of the cases involve professions that require their

members to be qualified or certified under a national law, such as doctors, lawyers, and engineers. The problem is that national qualification standards vary from country to country. Therefore, a lawyer qualified to practice law in Romania is unlikely to meet the qualification requirements of France. The EU has responded by adopting numerous directives providing for the mutual recognition of qualifications in specific professional fields.

Freedom of Establishment

Article 43 of the Treaty of Rome prohibits restrictions on the freedom of establishment by EU nationals. This includes the right to establish agencies, branches, or subsidiaries in other countries of the EU. Article 43 defines the freedom of establishment to include “the right to take up and pursue activities as self-employed persons.”

In the area of professional qualifications, the ECJ held that the Paris Bar Association was not justified in denying admission to a Belgium lawyer because he did not hold a degree in law from a French university, since a French university recognized his Belgium law degree as being equivalent to a French law degree. The case did not hold that simply because a person is a lawyer in one country that they can automatically practice law in other EU countries. The ECJ more narrowly held that holding a specific national law degree was not by itself a reason to deny admission to practice law in another country. For example, in the above case, the Belgium lawyer had passed the required French bar exam for admission to the profession of *avocat* (lawyer) in France.

The ECJ went a step further in the *Vlassopoulou* case²⁵ by holding that even if a foreign lawyer has not passed the bar examination of the country that the lawyer would like to practice, the national authorities were obliged to perform an *assessment of equivalence* (“comparison between the specialized knowledge and abilities certified by those diplomas and the knowledge and qualifications required by the national rules.”) In that case, a Greek lawyer had practiced with a firm of lawyers in Germany for a number of years, but he had not passed the German bar exam.

The **principle of mutual recognition** is established by Article 47 of the Treaty, which calls for the adoption of directives for the “mutual recognition of diplomas, certificates and other evidence of formal qualifications.” However, EU countries have been slow in recognizing foreign qualifications. Countries are most likely delaying such recognition to protect their citizens that practice in those areas.

Freedom of Services

The Treaty rules on the freedom of establishment and services were part of the goal of creating the Common Market. Under the Treaty, the right to establishment and the right to provide services appear to be conditional on the adoption of directives. Nonetheless, the ECJ ruled that both Article 43 (freedom of establishment) and Articles 49 and 50 (freedom of services) have direct effect on national laws.

The Treaty expressly prohibited discrimination against foreign nationals or companies exercising their rights to establish a business or to provide services. The ECJ subsequently declared that the rules on establishment and services also apply to nondiscriminatory obstacles to free movement. The 2009 EU Services Directive²⁶ provides additional rules to facilitate the permanent establishment of business throughout the EU, as well as a cross borders services provision to more easily allow people and companies to provide their services in other EU countries, without establishing a permanent office or presence. The Directive covers a wide range of services including business, construction, educational, real estate, regulated professions (law, medicine, accounting, engineering, and so forth), and retail services. However, the Directive does not apply to financial, electronic communication, transport, healthcare, or social services.

Free Movement of Capital

The free movement of capital is essential to the functioning of a **common market** since it leads to more integrated, open, and efficient financial markets and services. Under a common market system, people should be able to freely open bank accounts, buy shares in nondomestic companies, and purchase foreign real estate. Companies from one country should be able to invest in and manage companies in other EU countries.

Despite the fact that freedom of capital is a fundamental principle of the EU since its recognition in the 1957 Treaty of Rome, *capital or exchange controls* remained in effect until the early 1990s. Capital controls require prior government authorizations before moving capital across national borders. In response to the array of country-level restrictions on the flow of capital, the Council adopted a capital liberalization directive, in 1988, leading to the removal of all remaining exchange controls by the mid-1990s.

Directive 88/361/EEC requires the removal of all restrictions of capital movements within the EU. See Figure 8.6 Comparative Law: “Summary of Council Directive” below. The Directive was affirmed in the Maastricht Treaty, which provides that all restrictions on capital movements and payments are prohibited whether between member countries or between a member country and a non-EU country. Unlike the Directive, the Treaty provision has direct effect in all EU countries. Before new countries can become EU members, they have to remove all national barriers to the free movement of capital.

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| <ul style="list-style-type: none"> • <i>Article 1, National Restrictions on Capital Movements are Prohibited:</i> Without prejudice to the following provisions, Member states shall abolish restrictions on movements of capital taking place between persons resident in Member states. Transfers in respect of capital movements shall be made on the same exchange rate conditions as those governing payments relating to current transactions. • <i>Article 2, Notification Requirement of Laws Impacting Capital Movements:</i> Member States shall notify the Committee of Governors of the Central Banks, the EU Monetary Committee and the EU Commission of their measures to regulate bank liquidity which have a specific impact on capital transactions carried out by credit institutions with non-residents. Such measures shall be confined to what is necessary for the purposes of domestic monetary regulation. • <i>Article 3, Exception for Emergency Measures:</i> Where short-term capital movements of exceptional magnitude impose severe strains on foreign-exchange markets and lead to serious disturbances in the conduct of Member states monetary and exchange rate policies, being reflected in particular in substantial variations in domestic liquidity, the Member may take protective measures. The Commission and the other Member States shall be informed of such measures by the date of their entry into force at the latest. The Commission, after consulting the EU Monetary Committee and the Committee of Governors of the Central Banks, shall decide whether the Member state may continue to apply the measures or whether it should amend or abolish them. The period of application of protective measures taken pursuant to this Article shall not exceed six months. | <ul style="list-style-type: none"> • <i>Article 4, National Regulation of Banks and Taxation:</i> Member states have the right to take all requisite measures to prevent infringements of their laws and regulations in the field of taxation and supervision of financial institutions. Application of those measures and procedures may not have the effect of impeding capital movements carried out in accordance with EU law. • <i>Article 6, Tax Evasion:</i> The Commission shall submit to the Council proposals aimed at eliminating or reducing risks of distortion, tax evasion and tax avoidance linked to the diversity of national systems for the taxation of savings and for controlling the application of these systems. • <i>Article 7, International Capital Movements and Consultation:</i> In their treatment of transfers in respect of movements of capital to or from third countries, the Member States shall endeavor to attain the same degree of liberalization as that which applies to operations within the EU. Where large-scale capital movements to or from third countries seriously disturb the domestic or external monetary or financial situation of Member states or cause serious strains in exchange relations within the EU or between the EU and third countries, Member states shall consult with one another on any measure to be taken to counteract such difficulties. • <i>Article 8, EU Monitoring:</i> The EU Monetary Committee shall annually examine domestic regulation of credit, financial, and monetary markets to determine their impact on international capital movements and on all other aspects of this Directive. The Committee shall report to the Commission on the outcome of this examination. The Directive's expansion of the free movement of capital was necessary for the EU to develop a fully independent economic and monetary union. |
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Figure 8.6 Comparative Law: “Summary of Council Directive 88/361/EEC.”

What are capital movements?

- 1 Movement of money from an investor in one country to a financial institution in another country
- 2 Foreign Direct Investment (investing in or acquiring a foreign company)
- 3 Real estate investments
- 4 Securities investments (shares, bonds, trust instruments)
- 5 Loans and credits

There are some exceptions to the free movement of capital both within the EU and with third party countries. These are primarily linked to taxation, supervision, public policy considerations, money laundering, and financial sanctions imposed under the Common Foreign and Security Policy, as was done against Russia during the crisis in the Ukraine.

EU Charter of Fundamental Rights

The Charter of Fundamental Rights was originally adopted on December 7, 2000, but did not become EU law until 2009 under the Maastricht Treaty. Violations of the long list of rights in the Charter are now illegal under EU law. However, the United Kingdom and Poland negotiated in the Treaty of Lisbon an opt-out relating to the Charter. Therefore, the Charter does not apply in those two countries, meaning citizens from those two countries cannot challenge a violation of rights found in the Charter at the ECJ or in their respective national court systems.

The Charter contains some 54 articles divided into seven titles. The first six titles deal with substantive rights under the headings: dignity, freedoms, equality, solidarity, citizens' rights, and justice, while the last title deals with the interpretation and application of the Charter. A brief review of the six titles shows the breadth of the Charter.

The first title, "Dignity," has five articles, relating to: (a) human dignity, (b) the right to life, (c) the right to integrity of the person, (d) the prohibition of torture and inhuman or degrading treatment or punishment, and (e) the prohibition of slavery and forced labor. It guarantees the right to life and prohibits torture, slavery, the death penalty, eugenic practices, and human cloning.

The second title, "Freedoms," has 14 articles, relating to: (a) the right to liberty and security; (b) respect for private and family life; (c) the protection of personal data; (d) the right to marry and the right to found a family; (e) freedom of thought, conscience, and religion; (f) freedom of expression and information; (g) freedom of assembly and association; (h) freedom of the arts and sciences; (i) the right to education; (j) the freedom to choose an occupation and the right to engage in work; (k) the freedom to conduct a business; (l) the right to property; (m) the right to asylum; and (n) protection in the event of removal, expulsion, or extradition. It covers liberty, personal integrity, privacy, marriage, thought, religion, expression, assembly, education, work, property, asylum, and protection of personal data.

The third title, "Equality," has seven articles, relating to (a) equality before the law; (b) nondiscrimination; (c) cultural, religious, and linguistic diversity; (d) equality between women and men; (e) the rights of the child; (f) the rights of the elderly; and (g) the integration of persons with disabilities. It covers equality before the law; prohibition of all discrimination including on the basis of disability, age, and sexual interpretation; cultural, religious, and linguistic diversity; the rights of children; and the elderly.

The fourth title, "Solidarity," has 12 articles, relating to (a) workers' right to information and consultation within the undertaking, (b) the right of collective bargaining and action, (c) the right of access to placement services, (d) protection in the event of unjustified dismissal, (e) fair and just working conditions, (f) the prohibition of child labor and the protection of young people at work, (g) family and professional life, (h) social security and social assistance, (i) health care, (j) access to services of general economic interest, (k) environmental protection, and (l) consumer protection. It covers social and workers' rights, including the right to fair working conditions, protection against unjustified dismissal, and access to health care, social, and housing assistance.

The fifth title, "Citizens' Rights," has eight articles, relating to (a) the right to vote and to stand as a candidate at elections to the European Parliament, (b) the right to vote and to stand as a candidate at municipal (local) elections, (c) the right to good administration, (d) the right of access to documents, (e) the right to seek assistance of the European Ombudsman, (f) the right to petition the European Parliament, (g) freedom of movement and of residence, and (h) diplomatic and consular protection. It covers the rights of the EU citizens such as the right to vote in elections to the European Parliament and to move freely within the EU. It also includes several administrative rights such as a right to good administration, to access documents, and to petition the European Parliament.

EU Citizenship: Any person who holds the nationality of a member country is automatically an EU citizen. EU citizenship is additional to and does not replace national citizenship. EU citizens are free to move and reside within the EU, run as a candidate for the EU Parliament, and receive equal access to EU civil servant jobs.

The sixth title, “Justice,” has four articles, relating to (a) the right to an effective remedy and to a fair trial, (b) the presumption of innocence and the right of defense, (c) the principles of the legality and proportionality of criminal offenses and penalties, and (d) the right not to be tried or punished twice in criminal proceedings for the same criminal offense.

A predecessor Human Rights law was sponsored by the Council of Europe, which is a nongovernmental organization and is not related to the EU. The European Convention on Human Rights (ECHR) is an international treaty that went into force on September 3, 1953. The Council of Europe is made up of 47 European countries. All European countries have joined except for Belarus, Kazakhstan, and Vatican City. The countries also established the European Court of Human Rights. Any individual can bring suit against any member country for violation of the Convention.

Importing Goods into the EU

As noted earlier, the most beneficial aspect of the EU to exporters from foreign countries and importers into the EU is the uniformity of the entry process and the freedom to move goods within the EU. A manufacturer-exporter may establish an office in one of the 28 EU countries, and once its goods clear customs in that country, the company is free to transship the goods throughout the EU. To make sure that the entry of the goods into the country of choice is a smooth process, most companies hire European customs agents to manage the importation process.

The process of importing goods begins with the filing of an *Entry Declaration Form C88*. Once the form is reviewed and entry accepted, payment of tariff duties and value-added taxes (VAT) are calculated and paid. The tariff and VAT owed are determined using the EU **Customs Procedure Code (CPC)**. In order to calculate the proper tariff or duty, the importer is required to provide: (1) a description of use and type of goods being imported (commercial invoice), whether they are to be used for consumption, reexportation, and whether they qualify for any exemptions; (2) a Commodity Code Number (harmonized tariff schedule classification), which also must be attached to the goods. The first type of information is used to determine the value of the goods and to derive the second type of information—the code or classification number. The classification number provides the tariff rate for the particular goods being imported. The rate is a percentage (*ad valorem*) that is multiplied against the value of the goods to determine the amount of duty owed. See Chapter 6 for a more in-depth analysis of the calculation of tariffs.

The importer needs to be aware that its goods must comply with all applicable quality, technical, and safety standards. The EU has made compliance with different national standards much easier. In the area of quality, the EU has developed the **CE mark** (*Conformité Européenne*). The CE mark harmonizes quality standards throughout the EU and was created under EU Directives 94/25/EC and 2003/44/EC. If the product has been CE mark certified, then the issue of quality is satisfied. The process of obtaining the CE mark is complicated. For example, each part of the product has to meet CE mark standards. For example, a motorboat must meet 50 or more different standards. CE quality must be verified before the goods are shipped to the EU. Fortunately, the EU has authorized private companies, called “notified bodies” (body) to provide the verifications. First, the body reviews the technical information pertaining to the product to determine if it meets the relevant standards. Second, the manufacturer has to provide the body with a sample so that it can verify that the product was built in accordance with the technical documentation. Third, the manufacturer must satisfy the body that they have an internal quality control system that ensures that all the products are produced in the same manner. Fourth, the manufacturer must submit to periodic audits of its production process and the check of random samples of their products in order to maintain their CE certification. Despite the time and costs of obtaining CE certification, it is commonly performed by manufacturer-exporters and expected, but not required, by European customs authorities.

Eurozone

The euro (€) is the official currency of 19 out of 28 EU member countries. These countries are collectively known as the Eurozone. The countries are Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, and Spain. The remaining nine countries have retained their own currencies: Bulgaria (lev or BGN), Croatia (kuna or HRK), Czech Republic (koruna or CZK), Denmark (krone or DKK), Hungary (Forint or HUF), Poland (złoty or PLN), Romania (leu or RON), Sweden (krona or SEK), and the United Kingdom (pound sterling or GBP). In 2015, the Greece debt crisis threatened to make it the first country to exit the Eurozone. A number of non-EU countries also use the euro as their national currencies, including Andorra, Kosovo, Montenegro, Monaco, San Marino, and Vatican City. The euro symbol was inspired by the Greek letter epsilon (ϵ), a reference to the cradle of European civilization and the letter “E” for Europe. The two parallel lines running through the symbol represent “stability.” See the below image of the euro symbol.

EU Competition Law

Articles 81 and 82 of the Treaty of Rome (currently Articles 101 and 102 of TFEU) established the core parameters of EU competition (antitrust) law. Article 81 of the Treaty outlaws monopolies, abuse of dominant positions (large market share), and anticompetitive collusion between competitors. The prohibition enshrined in Article 81(1) extends not only to agreements and decisions, but also to other more tacit forms of collusion characterized as “concerted practices.” An agreement found to infringe Article 81(1) is automatically void unless it satisfies the criteria for exemption set out in Article 81(3). A major debate in EU competition law is how the government and courts should balance the pro- and anticompetitive effects of an agreement.

New competition regulations entered into force in 2004. Regulation 1/2003 on the implementation of the rules of competition laid down in Articles 81 and 82 of the Treaty replaces Regulation 17/62 and marks a major shift in the need to obtain prior authorization, under which agreements had to be notified to the EU Commission (Directorate IV) in order to obtain approval, to a directly applicable exemption system. Under the new decentralized enforcement regime, national courts can for the first time apply the provisions of Article 81(3).

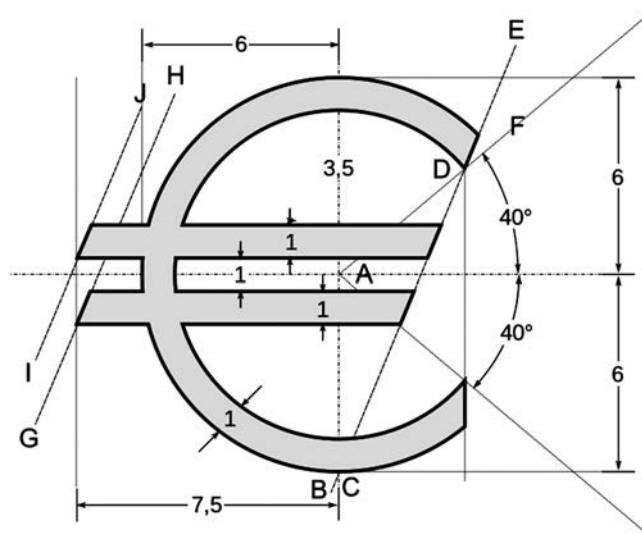


Image 8.1 Euro Symbol.

The exemption system categorizes different types of agreements (franchising, mergers and acquisitions below a certain market share, and so forth) as being exempt from the competition law. These exempt categories of types of agreements or activities are called **block exemptions**. The benefits of the block exemption system include: (1) reduced workload for the EU Commission and short delays in granting approvals, allowing it to focus its efforts on combating restrictive practices that most seriously distort competition and impede market integration; (2) easing of the administrative burden of firms doing business in Europe; and (3) increasing the part played by national competition authorities and national courts in implementing EU competition law. In areas where there is no applicable block exemption, the parties must receive formal approval from the EU Commission.

The various block exemptions currently in force include:

- *Franchising*: Regulation 2790/1999 (vertical distribution, purchasing, and franchising agreements);
- *Licensing*: Regulation 240/96 (technology transfer agreements);
- *Auto Dealerships*: Regulation 1400/2002 (vertical agreements and concerted practices in the motor vehicle sector);
- *Specialization*: Regulation 2658/2000 (specialization agreements); and
- *Research & Development*: Regulation 2659/2000 (research and development agreements).

Chapter Summary

- 1 The EU is founded on a series of Treaties beginning with the Treaty of Paris in 1953 and the Treaty of Rome that established the European Economic Community (EEC). Other Treaties changed the EEC to a broader European Community (EC). The EC was transformed into the European Union (EU) with the enactment of the Maastricht Treaty, officially known as the “Treaty of the European Union” or TEU. The TEU established the EU as a separate governmental political entity. The 2009 implementation of the Treaty of Lisbon made the EU a fully functioning democratic government.
- 2 The seven EU institutions are the Council of the EU (Council), the European Council, Parliament, Commission, European Court of Justice, European Central Bank, and the Court of Auditors.
- 3 The four freedoms embedded in EU law are the free movements of persons, goods, services, and capital.
- 4 EU law prohibits countries from indirect discrimination against imported goods in favor of domestic goods. Disguised or unintentional restrictions on trade are referred to as measures equivalent to a quantitative restriction (MEQR).
- 5 The two lawmaking bodies are the Council and the Parliament. Most laws are passed under the “ordinary legislative procedure,” which requires a majority vote of the Parliament and a “qualified majority vote” (QMV), also known as double majority, voting in the council.
- 6 EU lawmaking is limited by the principles of subsidiarity and proportionality. The principle of subsidiarity holds that the EU may only act (make laws) where action of individual countries would be insufficient. The principle of proportionality holds that the content and form of EU law shall not exceed what is necessary to achieve the objectives of the Treaties.
- 7 The two major types of laws enacted by the Council and Parliament are regulations and directives. Regulations have direct effect, meaning that upon enactment they immediately become part of the national laws of the member states. Directives do not have direct effect, but only become part of national law through a further legislative action at the national level. Because of the need for subsequent legislation, the implementation of the principles and rules of directives may vary across EU countries.
- 8 The European Court of Justice (ECJ) is the supreme court of the EU that hears claims brought by: (a) EU institution against a member country for violations of EU law or failure to implement a EU law (directive), (b) member country against the EU for overstepping its powers (competencies) under EU treaties, (c) member country against member country for violating EU law (disguised restrictions on imports), (d) individual EU citizens or nationals

against member country for failing to obey EU law or for damages caused by country's failure to implement EU law, and (e) referrals from national courts requesting an interpretation of EU law.

- 9 The Charter of Fundamental Rights provides a litany of rights based upon six tenets: Dignity, Freedom, Equality, Solidarity, Citizens' Rights, and Justice.

Key Terms

<i>Acquis communautaire</i>	EU Council	Measure Equivalent to a
Block Exemptions	EU Parliament	Quantitative Restriction (MEQR)
CE Mark	European Central Bank (ECB)	Ordinary Legislative Procedure
Charter of Fundamental Rights	European Convention on Human Rights (ECHR)	Per Capita GDP
Co-Decision	European Council	Principle of Conferral
Committee of Permanent Representatives (Coreper)	European Court of Human Rights (ECHR)	Principle of Mutual Recognition
Common Market	European Court of Justice (ECJ)	Principle of Nondiscrimination
Competencies	European Union (EU)	Principle of Proportionality
Exclusive Competency	Eurozone	Principle of Subsidiarity
Shared Competency	Four Freedoms	Principle of Supremacy
Supporting Competency	Free Movement of Capital	Public Morality Clause
Competition Law	Free Movement of Goods	Qualified Majority Voting (QMV)
Customs Procedure Code (CPC)	Free Movement of Persons	Regulations
Direct Effect	Free Movement of Services	Schengen Agreement
Directives	International Monetary Fund (IMF)	Special Legislative Procedures
Directorates Generals (DG)	Maastricht Treaty (Treaty of the European Union or TEU)	Treaty of Lisbon
Double Majority Voting		Treaty of Paris
EU Citizenship		Treaty of Rome (Treaty on the Functioning of the European Union or TFEU)
EU Commission		

Chapter Problems

- Match the terms on the left with the ones on the right (answer key is given on p. 254):

i. Direct Effect	a. Principle of Legitimate Expectation
ii. Equal Treatment Directive	b. MEQRs
iii. Maastricht Treaty	c. European Convention on Human Rights
iv. Indirect Discrimination	d. Principle of Mutual Recognition
v. Competition Law	e. Department of EU Commission
vi. CE Mark	f. Ordinary Legislative Procedure
vii. EU Commission	g. Treaty of the European Union (TEU)
viii. Double Majority Voting	h. EU is Government of Limited Powers
ix. Directorate	i. Regulation
x. Principle of Conferral	j. Issues Binding "Decisions"
xi. Council of Europe	k. Quality Standard
xii. No Retroactive Laws	l. Block Exemptions
- Why would EU lawmakers choose the directive form of law over the regulation form of law? What difference does it make to EU nationals and companies? Why would the directive form of law influence a foreign (non-EU) company in choosing an EU country to invest or establish an office?
- The Schengen Agreement was meant to erase the national borders between countries to allow the unrestricted movement of persons. Immigration from crises in Africa, Syria, and internal migration from poorer to richer countries of the EU has led some countries to question the benefits of being a Schengen country. The issue of the free flow of immigrants into EU countries has also led to the rise of nationalist, anti-immigration parties in some EU countries. Should the EU reconsider or modify the principle of the free movement of persons? How can the EU balance the fundamental

- policy of free movement of persons with the concerns of member states in controlling their borders?
- 4 Bulgaria is one of the poorer countries within the EU and does not seem to have benefited as much as other countries from its integration into the EU. Poland has proven to be a fully functioning democracy and was the only EU country that had relatively high growth rates during the “Great Recession” emanating from the financial crises of 2008. Compare the experiences of Poland and Bulgaria in joining the EU. What have been the problems in Bulgaria that have prevented it from substantially improving its standard of living and per capita GDP? What has Poland done correctly in developing its economy?
 - 5 Corruption has been a major problem in some of the newer members of the EU and in former countries of the Soviet Union. For example, the Transparency International’s Corruption Index for 2014 ranked the following European countries out of 175 countries (1= least corrupt; 175=most corrupt, and each country gets a score with 100 being a country without corruption and 0 being the most corrupt): Ukraine (146th ranking; Total Score: 26); Serbia (86th; 41); Bulgaria, Greece, Italy, and Romania tied (69th; 43); Croatia (61st; 48); Czech Republic (53rd; 51); and Hungary (47th; 54). Other EU countries among the least corrupt are: Denmark (1st; 92), Finland (3rd; 89), Netherlands (8th; 83), Germany (12th; 79), United Kingdom (14th; 78), Austria (23rd; 73), and France (26th; 69). What is the relationship between corruption and economic prosperity? Why have some EU countries been able to control corruption and others have failed? What has the EU done to assist anticorruption efforts in Bulgaria?
 - 6 Review the issues and provisions of the proposed free trade agreement (Transatlantic Trade and Investment Partnership or T-TIP) between the United States and the European Union. What areas does the T-TIP cover? Why is the T-TIP important?

Internet Exercises

- 1 Compare the United States Bill of Rights (First Ten Amendments to the U.S. Constitution) (available from many online sources including: http://www.archives.gov/exhibits/charters/bill_of_rights_transcript.html) with the European Union Charter of Fundamental Rights (available at http://www.europarl.europa.eu/charter/pdf/text_en.pdf). What differences can you find? What is found in one and not the other? Can you think of any reasons for the differences? Are most of the more specific rights provided in the EU Charter covered by the broader category of rights enunciated in the Bill of Rights?
- 2 Review the Europa web site (official web site of the EU) at <http://europa.eu>. Pretend you are deciding on whether to establish an office in Italy, Hungary, or Czech Republic. Go to the web site, click on “countries” under the category “How the EU Works,” and do some preliminary research. What are some of the benefits and risks of doing business in those three countries? Next, review and compare the information provided in the U.S. Commercial Country Guides (www.export.gov) for those three countries at www.export.gov/Italy (click on “Country Commercial Guide”); <http://www.export.gov/hungary>; (click “Doing Business in Hungary”); and <http://www.export.gov/czechrepublic> (click on “Market Research on Czech Republic”) and then click under “Country Commercial Guide.”

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European Central Bank: www.ecb.europa.eu.

European Central Bank, Ecosystem: <http://www.ecb.europa.eu/euro/html/index.en.html>.

[Answers to Problem 1: i(i); ii(d); iii(g); iv(b); v(l); vi(k); vii(j); viii(f); ix(e); x(h); xi(c); xii(a).]

Notes

- 1 Bruce Carolan, *EU Law for Students in Ireland* 130–135 (2009); In memoriam: Professor Carolan passed away during the writing of this book. He was truly a gentleman and a scholar.
- 2 [2007] ECR I-3633.
- 3 [2006] ECR II-3435.
- 4 Bruce Carolan, *EU Law for Students in Ireland* (2009) (much of the material in this section was influenced by Professor Carolan's excellent analysis of EU law).
- 5 Eurojust coordinates investigations and prosecutions between the legal authorities of different member states, in particular by facilitating the implementation of extradition requests.
- 6 Europol is the European Union's law enforcement agency.
- 7 Bruce Carolan, *EU Law for Students in Ireland* 80–82 (2009).
- 8 [1963] ECR 1.
- 9 Note this case occurred prior to the removal of all tariffs between countries of the EU.
- 10 Bruce Carolan, *EU Law for Students in Ireland* 84 (2009).
- 11 TEU, Article 25.
- 12 TEU, Articles 28 and 30.
- 13 [1979] ECR 649.
- 14 Bruce Carolan, *EU Law for Students in Ireland* 128–129 (2009).
- 15 [1985] ECR 1367.
- 16 Bruce Carolan, *EU Law for Students in Ireland* 194 (2009).
- 17 [1974] ECR 837.
- 18 [1979] ECR 3795.
- 19 [1984] ECR 2727.
- 20 [1982] ECR 2793.
- 21 Bruce Carolan, *EU Law for Students in Ireland* 184 (2009).
- 22 [1969] ECR 193.
- 23 *Van Duyn v. Home Office* [1974] ECR 1337.
- 24 [1982] ECR 1665.
- 25 [1991] ECR 2357.
- 26 Directive 2006/123 effective December 28, 2009.

EMERGING ECONOMIES: CHINA

BRIC Countries

Beginning in the 1980s a number of national economies moved from impoverished or lesser-developed status to being relabeled as emerging economies. Four of these economies became known as the **BRIC countries**—Brazil, Russia, India, and China—due to their tremendous growth rates. Out of the BRIC Countries, China is the most important to world trade from demographic and economic perspectives. This chapter will focus on doing business in the People’s Republic of China (PRC or China); more specifically, the focus will be on Mainland China, although doing business in Hong Kong will also be briefly discussed. In more recent times, South Africa and, to a lesser extent, Turkey have been recognized as BRIC-like countries. The diminishment of the Russian economy beginning in 2014 will be analyzed in Chapter 20’s coverage of “Foreign Direct Investment (FDI).”

The 2015 Gross Domestic Product (GDP)¹ in U.S. dollars of the BRIC countries are as follows: China (nearly \$11 trillion), India (\$2.1 trillion), Brazil (\$1.8 trillion), and the Russian Federation (\$1.325 trillion). These numbers make the BRIC countries the number 2nd, 7th, 9th, and 12th largest economies in the world. Combined, the BRIC economies have a total GDP of \$16.2 trillion. Unfortunately, the GDP of Brazil and Russia has been on the decline in recent years. For example, the GDP in 2013 for Brazil and Russia was 2.46 and 2.3 trillion dollars respectively. The U.S. size of the economy was \$17.95 trillion, the combined NAFTA economies (Canada, Mexico, U.S.) was approximately \$20.7 trillion, and the combined GDP for the European Union (EU) in 2015 was close to \$19 trillion. In many ways, the world can be divided into three major trading blocs: U.S. (or NAFTA), EU, and China. Japan remains an important economy and trading power.

The perspective on the BRIC economies has changed somewhat as growth rates have decreased in recent years. Brazil has seen their growth rates slow following the Financial Collapse of 2008; Statista.com reports that Russia had a negative growth rate of 3.8% in 2015, a further contraction of 3.8% is expected for 2016, and a modest projected positive growth of 1 to 1.5% through 2020 due to: (1) Western sanctions stemming from the Russian invasion of Crimea and its involvement in an uprising in the eastern part of the Ukraine, (2) the collapse of oil prices, (3) the resulting devaluation of the Russian ruble, and (4) the outpouring of foreign investment. As noted above, the Russian economic crisis will be reviewed in Chapter 20. Here, it serves to illustrate that emerging economies vary in their capacities and weaknesses, and there is no guarantee that such economies will join the ranks of developed countries. At the least, the progression to higher levels of economic development may include various setbacks and take various lengths of time to achieve. The Russian crisis provides an example that a developing country may be its own worst enemy. Russia is a sensational case. A major factor in its demise was its invasion of the Ukraine in violation of international law. More common reasons for a country’s struggle to advance economically include: (1) high rates of corruption, (2) failure to restructure their economies to be more open and reduce waste and efficiency in its regulatory and government structures, and (3) failures to diversify their economies. Russia is a prime example of the latter phenomenon. The country remains largely dependent on revenues generated by its oil and gas sector. With the radical drop in oil prices beginning in 2014 and the crash in the value of the ruble, the Russian economy collapsed into recession in 2015–2016.

While other BRIC countries have struggled to maintain strong growth rates, China has been the exception with strong growth rates continuing through the recession. However, its growth rates have slowed from the double-digits growth rates of the past to about 6 to 7 percent, mainly due to the slowing of its economy and the need to restructure its financial markets. The International Monetary Fund's 2016 and 2017 projected growth rates for developing and developed economies include: European Union at 1.8 and 1.9%, China at 6.5 and 6.2%, Brazil at -3.8 percent, Russia at -3.8 and 0%, Japan at .5 and -.1%, France at 1.1 and 1.3%, Germany at 1.5 and 1.6%, Canada at 1.5 and 1.9%, and the United States at 2.4 and 2.5%. This chapter will focus on doing business in the world's second largest economy. China is perceived as a primary source of manufacturing, raw materials, and component parts, in addition to being a major market for end products. It will continue to be one of the major trading partners of the U.S.

People's Republic of China

China has come a long way economically in a short period of time. China was a closed, planned (socialistic) economy with little inward foreign investment and a restricted international trade sector. In 1978, China adopted the **Open Door Policy** that led to the gradual opening of China to foreign investors; its bilateral investment treaty (BIT) program, cautiously inaugurated in 1982, has been widely used throughout the world. Beginning in the early 1980s, China enacted a variety of Western-style laws in the process of transitioning to a market economy. China was admitted to the World Trade Organization (WTO) in 1981.

China's tremendous GDP growth since the 1980s has shown its ability to develop a market economy and robust international trade sector within a nondemocratic political regime. However, at present, it has become apparent that in order to develop a more mature, developed economy it will have to continue opening up to the outside world by loosening restrictions on its financial markets and refrain from manipulating the value of its currency (*yuan*). It will also have to transition from low-wage, cheap-goods manufacturing to a more innovation-driven economy. Already, other countries have become more competitive in producing goods more cheaply due to lower wage rates. China is aware of these issues and has begun to take steps to restructure its economy, including the implementation of an anticorruption campaign in 2014. But China is limited to the degree of openness it can obtain given the totalitarian nature of its political system, where the power lies in a nongovernmental institution—the Communist Party.

China's economic expansion is largely due to the mobilization of its large population, which is approaching 1.4 billion. Its economy has grown to be the second largest at about \$11–14 trillion in GDP and is expected to overtake the U.S. economy. However, it's important to realize that China's GDP is spread among a much larger population. Therefore, its per capita GDP remains far behind the U.S. and other developed countries. That said, the growth of its economy has been reflected in a tremendous improvement in per capita GDP, from under \$400 in 1980 to \$7990 in 2015 (as reported in Statista.com). The size of its industrial and manufacturing sector now rivals that of the U.S. See Figure 9.1 for “Map of China.”

China has been able to sustain such growth despite a lack of economic freedom. The Heritage Foundation ranks China as 31 out of 42 countries in the Asia-Pacific region and 144th ranked in the world in economic freedom.² Some of the reasons for this ranking include: (1) China's weak judicial system, which is highly vulnerable to political influence; (2) power and wealth is concentrated in **state-owned enterprises (SOEs)** and local governments; (3) lack of labor mobility; (4) high levels of corruption in government and in the judicial system; (5) high levels of bureaucratic obstacles to obtain necessary licenses and permits (regulatory inefficiency); and (6) SOEs benefit from greater access to capital and lower financing costs, but small and medium-sized companies continue to suffer from the lack of access to credit.

Language and Culture

Language can be a major issue for foreigners doing business in China. The Chinese language does not have an alphabet but instead makes use of characters. An educated person will know 3,000 or more characters. Even though Mandarin is China's official language, there are hundreds of different languages and dialects. The most



Figure 9.1 Map of China.

<p style="text-align: center;">Health Information</p> <p>Centers for Disease Control (www.cdc.gov)</p> <p style="text-align: center;"><u>Travel to China</u></p> <p>(Recommended Vaccines)</p> <p>Hepatitis A & B Typhoid Japanese Encephalitis Polio Booster Malaria</p> <p style="text-align: center;"><u>Other General Tips: “Don’ts”</u></p> <p>Drink Tap & Unsealed Bottle Water Eat Food from Street Vendors Use Insect Repellent (20 or more DEET) Keep away from Animals (chickens carry Avian Flu) Review Health Insurance Consider Travel Insurance</p>	<p>At times, Chinese businesspersons may not seem serious in the negotiating of contracts, but this appearance of antipathy is due to cultural differences. Chinese companies and government agencies are extremely hierarchical with minimal delegation of decision-making powers from senior to junior officers. Under this system, rank is of primary importance. This causes problems when Western companies send junior officers (middle management) with the power to negotiate contracts. In return, the government agency or company sends a junior officer that is lacking the authority to make a contract. The result, from the Western perspective, is that the Chinese party is delaying the negotiations and is not negotiating in good faith, when, in fact, the junior officers need to present the proposals to senior officers who feel free to neglect what was agreed upon during the negotiations. Therefore, it is important that the Western company send a high-ranking officer, depending on the size and importance of the deal. For the same reason, it is important to verify the authority of the party on the other side of the negotiations. When dealing with government officials, it is vital to find out which government officials have the power of approval and try to engage them in the negotiations as soon as is feasible. Finally, when traveling to foreign countries, the traveler should check their country’s health authorities for health safety alerts and recommended vaccines (see column to the left).</p>
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Figure 9.2 Negotiating in China.

important dialect other than Mandarin is Cantonese, which is spoken in Guangdong Province and in Hong Kong. Even though the written forms of these two languages have some similarities, a Mandarin-speaking person is not able to understand a Cantonese-speaking person. Much of this confusion is mollified by the fact that Mandarin is a compulsory topic in all schools in China, so the Cantonese-speaking person is likely to understand some Mandarin. Interestingly, investment flows have tracked the differences in languages. For example, investors from Hong Kong prefer investing in Guangdong Province, while investors from Taiwan who speak a Fukien dialect prefer investing in Fujian Province. Fortunately, English is also a mandatory school subject starting in primary school. The Chinese do an excellent job of teaching English with most of the college students being able to read English and to speak it at a relatively good level. In way of comparison, this is not the case in Japan.

Business decisions may prove unusually complex for foreigners seeking to do business in China. Evolving from Confucianism, the traditional Chinese culture places much more emphasis on the nurturing and maintenance of relationships than in most other areas of the world. This emphasis on relationships and connections is known as **Guanxi**:

Guanxi and Western models of approaching a transaction need to be viewed in tandem: a strong enough relationship gains entry to the Western model of negotiation and hopefully to an eventual contract and continued relationships. The bigger the risk, the stronger the *guanxi* will need to be. The process of securing a contract in China is rarely the free market auction paradigm Westerners expect. For example, the parties may determine the terms of a business contract; however, all the local implications of doing business (like dealing with suppliers) will be determined by *guanxi*.³

See Figure 9.2 above for a discussion of “Negotiating in China.”

Chinese Government

In 1992, a new **Constitution** or **Basic Law** was enacted, which provides the current structure of government, judicial system, and individual rights. It has three substantive parts that provide the general principles of government, the basic structure of government, and the fundamental rights and *duties* of citizens. The notion of the duties of citizens demonstrates the difference between a democratic constitution and a socialist constitution. In democracies with constitutions, or as referred to in some countries as the “basic law,” the constitution is seen as the supreme authority. In China, the Communist Party is the supreme authority and not the Constitution and law in general. As such the PRC’s Constitution is more a statement of policies. The fact that it is not fundamental law in the way of the U.S. Constitution, is shown by the fact that the 1992 Constitution is the fourth constitution enacted since 1949. The common division of authority between executive, legislative, and judicial branches characterizes the Chinese governmental structure. However, the allocation of power and independence of the three branches does not reach anywhere close to the separation of powers created by the U.S. Constitution. Later in this chapter there will be a discussion of the Communist Party as the key power structure in China.

Executive Branch

The most powerful positions in the Chinese government are the President and Vice President, who are elected by the **National People’s Congress (NPC)**. They have five-year terms and are limited to two consecutive terms. The **State Council** is part of the Executive Branch of government. It is the highest organ of the government and consists of Premiers, Ministers, and Councilors. Ministers head the numerous ministries or commissions of government. Members of the State Council are limited to five-year terms. The State Council and its Ministries are equivalent to the executive and legislative agencies of the U.S. government. The Ministries adopt regulations, rules and orders, as well as prepare proposals to submit to the NPC, such as plans for economic development, foreign affairs, and approval of international treaties and agreements.

Legislative Branch

People’s congresses exist at all levels—national, regional, and local. The most powerful is the NPC. They make up the basic units of political power in China. Deputies to the town and local congresses are directly elected. The deputies at the lower levels elect deputies at the county level. The NPC’s **Standing Committee** is the highest level of legislative power. The NPC is responsible for creating and supervising all administrative and judicial units of the government. The NPC is empowered to approve plans for economic and social development, and approves the national budget. The legislative powers of the NPC include electing the President, amending the Constitution, enacting basic laws, and electing the President of the Supreme People’s Court. The NPC meets only once a year for two weeks. When not in session, the Standing Committee exercises all the above listed powers of the NPC.

Judicial Branch

The judicial system consists of the **Supreme People’s Court**. Article 129 of the Constitution describes the courts as “state organs for legal supervision.” The courts are accountable to the Standing Committee. Below the Supreme People’s Court are 31 Higher People’s Courts and 376 Intermediate People’s Courts at the provincial level; below these courts are some 3,000 Basic People’s Courts at the county level, which are further subdivided into town and village courts called People’s Tribunals. Litigants are generally limited to one appeal on matters of law but have a right to two trials—after the decision at the trial level the case may be reviewed *de novo* (on matters of facts and law). After the second trial there is no right to appeal, even as to matters of law.

Chinese Legal System

China's rise as an economic superpower is symbolized by its obtaining full membership into the WTO on December 11, 2001. This membership gave it the benefit of the lower WTO tariffs for its exports, further increasing its competitiveness. At the same time it obligated itself to undertake fundamental reforms in such areas as transparency of laws, protection of intellectual property rights (IPR), removal of illegal government subsidies to industry, and opening access to government procurement, as well as opening access to its overall markets. WTO membership also recognized how far China had come in creating a modern legal system, as well as a body of free-market-oriented substantive laws. Chinese substantive law will be reviewed later in the chapter.

The modern Chinese legal system is a relatively new creation. The recent history of China shows that the People's Republic of China was created in 1949 as a communist state with a planned economy. The government owned all property, or the property was held in some form of communal ownership. The center of the industrial economy was the SOE system. A far-reaching and complex government bureaucracy controlled all facets of industry. Due to the inefficiencies of such a system, China failed to take advantage of its enormous economic potential. All social reforms and economic progress came to an end with the purge known as the Cultural Revolution, beginning in 1966 and ending with the death of **Mao Zedong** in 1976.

Modern China was essentially constructed beginning with the ascendancy of **Deng Xiaoping** to power in 1978. Deng immediately began the institution of economic reforms leading to the market economy of today. He also revived the legal system which had all but ceased to function in order to support the economic rule of law. Eighty three percent of industrial output was controlled by SOEs before the 1978 economic reforms began. An OECD study using data from 2006 estimated the SOE share of GDP to be 29.7 percent (according to Junyeop Lee's *State Owned Enterprises in China* [OECD 2009]). Despite this rapid improvement, the government remains firmly in control of such important areas as banking, electricity, steel production, oil and gas exploration, telecommunications, and transport systems. It is in these markets that foreign investment and competition has been prohibited. It is in these areas that further reforms (privatization) are needed.

Chinese Constitution

The Constitution of the PRC guarantees the basic rights of citizens including the right to vote, freedom of speech, press, assembly, association, religion, as well as a rights to personal dignity, to criticize, to work, to education, and to material assistance from the state and society. In 2014, the Constitution was amended to expressly guarantee human rights and recognized private assets, but not necessarily real estate from encroachment by public authorities.

In preparation for its entry into the WTO in 2001, there was a rapid passage of all sorts of laws to conform to the requirements of the different WTO Agreements. Included in the massive creation of laws and regulations was an effort to improve its legal system. International treaties are not discussed in the Constitution, but the practice is to automatically incorporate international treaties and agreements into the law of the PRC. As a civil law system, decisions of higher courts have no mandatory precedential value—each case stands alone and does not bind other courts. However, in practice, the lower courts attempt to follow the interpretations decided by the Supreme People's Courts. See Figure 9.3 for the structure of the "Chinese Court System."

Organization and Responsibilities of People's Courts

According to the current Constitution, and the **Law on the Organization of People's Courts**, People's Courts represent the main trial organ of the state. Organizationally, this court system consists of local courts, special courts, and the Supreme Court, with the first two subject to the supervision of the latter. Local courts are divided into three levels. Intermediate Courts are those set up in prefectures, cities directly under provinces (autonomous regions and municipalities directly under the central government), and districts in the four municipalities directly under the central government (municipalities). First-hearing (trial) cases under their jurisdiction include those involving national security, criminal cases that may involve life imprisonment or the death penalty, criminal cases committed by foreigners, or cases involving Chinese citizens violating the lawful rights and interests of foreigners.

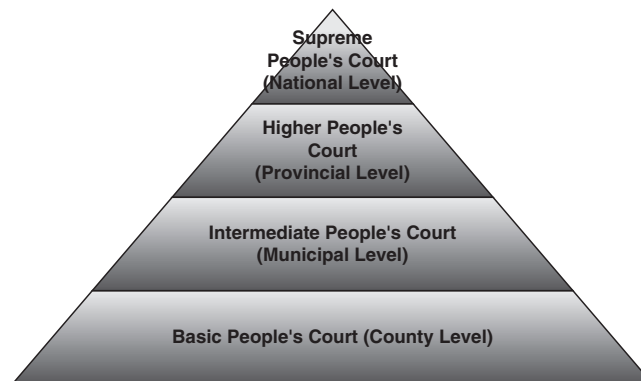


Figure 9.3 Chinese Court System.

According to the Law on Civil Procedure, civil cases heard by Intermediate Courts are major foreign-related cases, cases of major implications within their jurisdictions, and cases that Intermediate Courts are ordered to hear by the Supreme Court. Intermediate Courts are authorized to hear the following cases: verification of patent rights, customs cases, and suits against administrative actions taken by governments of the provinces. Their jurisdiction also includes trial cases transferred by lower courts and they have the power to examine decisions of the lower courts.

Higher Courts are set up in provinces (autonomous regions and municipalities). Their responsibilities include: (1) criminal, civil, and administrative cases of major proportions and complications under their jurisdiction, as provided for by the law; (2) first-hearing (trial) cases transferred by lower courts; (3) cases appealing or protesting the verdicts and decisions made by lower courts; (4) cases appealing the verdicts and rulings made by the Maritime Court.

Maritime Courts are special courts set up to hear maritime or sea-shipping cases for the purpose of exercising judicial jurisdiction over maritime affairs. In May 1989, the Supreme People's Court made a Decision on the Scope of Cases to Be Handled by Maritime Courts. That decision specified that Maritime Courts handle maritime or commercial cases between Chinese citizens, between Chinese citizens and foreign citizens, and between foreign citizens. These cases fall into a number of categories: maritime torts and disputes, damage claims involving the collision of vessels, claims involving vessels discharging or leaking hazardous materials, and claims involving casualties in the course of sea-borne shipping. It also hears commercial disputes involving shipping contract disputes, contract dispute cases involving passengers and baggage, cases involving seaman labor contract disputes, cases involving maritime insurance contract disputes, and cases involving applications filed with Chinese Maritime Courts by litigants for recognition and the enforcement of arbitration awards.

The Supreme People's Court, located in Beijing, supervises lower courts and special courts and reviews lower courts' judgments and rulings that have been found to contain errors. It also has jurisdiction over criminal and civil cases of major proportions nationwide, such as approval of death penalty cases and issuing of judicial interpretations on how to apply the law.

Judges are elected with the following qualifications: (1) citizen of the PRC; (2) 23 years of age; (3) in good *political*, professional, and moral standing; (4) in good health; and (5) holder of a bachelor's in law with a full year of working experience. Those holding a master's or PhD degree in law are not subject to the working-experience requirement described above. Presidents of courts at local levels are elected and removed by the People's Congress at the same level, and the tenure of the presidents is the same as the People's Congress; the president nominates the vice president, members of the Judicial Committee, presiding judges, deputy presiding judges, and judges for appointment and removal. The **Standing Committee of the People's Congress** at the same level has the power to approve appointments and to remove judges. Judges must not engage in anti-government gatherings, demonstrations, and protests; participate in strikes; embezzle or take bribes; neglect

duties resulting in wrong rulings or serious damages to litigants; purposefully delay proceedings; abuse power to seek profit for themselves or others; engage in business activities; meet in private with litigants and their representatives; or accept gifts and favors.

Article 12 of the Law on the Organization of People's Courts requires courts to try cases on two levels, with the second instance being the final judgment. This means a case is closed after going through two levels of trial. The superior court, after reviewing appealed or protested cases in accordance with second-instance procedures, passes a judgment or ruling that acts as the final judgment. Because of the two-court trial system, there is no further right to appeal. In order to compensate for the lack of a right to a further appeal, the **System for Judicial Supervision**, also known as the *reexamination system* was created. This system refers to a special arrangement for the court to reexamine judgments and rulings that have already taken effect. It actually represents a remedy to the system where the decision of second instance (trial) is final. The requirements to use the system include: (1) the lower court judgment or ruling has been found to contain errors in the establishment of facts or application of laws; (2) the judicial supervision procedure can only be initiated by presidents of courts, superior courts, and the Supreme People's Court. In reexamining a case under the judicial supervision procedure, judges from a separate Judicial Panel are used.

Some cases are referred directly to a higher court. In such cases, the trial results from the higher court are final with no right to appeal. Such referrals can be done at any level including from a higher court to the Supreme People's Court, and, at the local level, common cases for referral include voter qualification cases, cases determining citizens to be legally disabled, and cases determining ownership of unclaimed property. In sum, the Chinese Court System functions differently than the appellate court systems found in the U.S. federal and state court systems. As is clear from the above discussion, the Chinese courts no matter the level often act both as trial courts and as courts of appeal. In the U.S., there is an automatic right to appeal on matters of law. In some U.S. states, a split decision on appeal triggers a right to a second appeal to a higher court.

Matter of Law: In legal actions, the term *matter of law* is used to define a particular area that is the responsibility of the court. Matter of law is distinguished from *matter of fact*. All questions concerning the determination of fact are for the jury, though a judge may determine the facts if a jury trial is waived or is not permitted under the law. Judges rule on all matters of law, including pretrial motions, trial objections to the introduction of particular evidence or testimony, proposed jury instructions, and post-trial motions.

Due to the lack of a proper appeals process and the newness of China's law codes, the Supreme People's Court has needed to innovate to provide guidance to lower courts in the application of these new Western-style laws. For about two decades, the Court has issued **Interpretative Decisions** or Guides explaining how the lower courts should deal with issues of how laws should be interpreted and applied (many of these Interpretive Decisions have been translated into English). Since China has a civil law system, the Supreme People's Court's interpretations are not mandatory in nature, but are viewed as persuasive sources of law. A more recent innovation has been the publication of **Guiding Cases**. Under this new case guidance, higher people's courts shall actively recommend and report guiding cases to the Supreme People's Court. The Supreme People's Court has specially set up a "case guidance office to strengthen and coordinate research on guiding cases." The "guiding cases" are ones that satisfy any of the following requirements: (a) issues of wide interest to society, (b) when the enacted law is not specific enough, (c) cases that are considered to be common or typical, or (d) complicated cases or new types of cases.

Role of Lawyers

Article 1 of the **Lawyers Law** states that the mission of lawyers is to maintain the lawful rights and interests of the parties to a suit and maintain proper implementation of law. Chinese lawyers play an independent role in lawsuits. They do not represent the courts, nor do they belong to their clients; they are independent. They participate in

lawsuits in order to maintain the legal rights and interests of the parties. According to Article 6, “The state shall administer a national examination to determine lawyer qualifications. Persons with a three-year college education in law and above or with equivalent qualifications, as well as persons with a bachelor’s degree in other disciplines and above, can be awarded lawyer’s qualifications by the State Council after passing the national examination.” One year of practice at a law firm is required to obtain a license to practice law. Lawyers practice in the name of their law firms. The Lawyers Law provides for three forms of law firms: state-funded, cooperative, and partnership. Article 23 states that lawyers should undertake business through their law firm, which should sign a written contract with their clients, charge them fees in compliance with state regulations, and record the fees faithfully into their books.

Arbitration Law and Arbitration Panels

Arbitration committees are formed with members from government departments and chambers of commerce and are registered with the judicial administration of the province (municipality, autonomous region). The **Arbitration Law of the People’s Republic of China**, promulgated on August 31, 1994, unified arbitration practices across the country and harmonized China’s arbitration system with internationally accepted principles and practices. The **China Arbitration Association** is a self-disciplinary organization of arbitrators. It supervises arbitration committees and their members. Arbitrators must meet the following qualifications: (1) eight full years in the arbitration field, eight full years in the legal profession, or eight full years as a judge; (2) specialized in legal research and teaching and holding a senior professional title; and (3) familiar with legal knowledge, specializing in economic and trade activities.

Arbitration is a preferred means of dispute resolution for foreigners for a number of reasons. First, the judicial expertise of the lower courts in the Chinese court system is uneven, especially when applying the Western-style laws adopted by China. Second, the courts can be slow and inefficient. Third, arbitration is party-controlled. The parties can negotiate a custom arbitration clause to alleviate the concerns of the foreign party, including selecting the language of the arbitration. Fourth, China has developed some outstanding arbitration venues and continues to develop a more expansive arbitration system. The major arbitration institution in China is the **China International Economic and Trade Arbitration Commission (CIETAC)**. From January 1, 2015, it simultaneously began using a new name: “Arbitration Institute of the China Chamber of Commerce.”

CIETAC was established in 1956 with its headquarters in Beijing. It also has offices in Shenzhen, Shanghai, Chongqing, and Hong Kong. It has a worldwide reputation and is one of the fastest growing arbitration venues in the world. As of 2014, CIETAC had issued more than 20,000 awards involving a party from a foreign country, and its awards have been enforced in more than 140 countries. It amended its rules (“2015 Rules”) to make them closer to international standards and practices. The new rules, as is the international trend, provide for the appointment of **emergency arbitrators** able to grant interim relief, such as injunctions. In 2014, a Chinese court, for the first time, upheld the validity of **hybrid arbitration clauses**. In that case, the arbitration clause called for CIETAC arbitration, but under the UNCITRAL Model Arbitration Rules. This makes CIETAC a more appealing venue for Western parties familiar with the Model Rules and unfamiliar with the CIETAC rules.

Chinese Substantive Law

After a brief review of Chinese legal history, the following substantive law areas, most closely related to doing business in China, will be reviewed: company and corporation law, property law, contract law, intellectual property law, investment law, joint venture franchise law, and administrative law.

History of Chinese Law

Traditional Chinese law was heavily based upon cultural practices in which formal law played a relatively minor role. The parties themselves, guided by cultural norms and customs, generally settled their own disputes. Confucianism was an important influence on the Chinese view of the role of law in society.

Confucius lived from 551–479 BC. The *Analects of Confucius* is a compilation of his sayings and ideas. He stressed personal and governmental morality, correctness of social relationships, justice, and sincerity. His work became the basis for Chinese tradition and thought. He is also credited with stating an early version of the *Golden Rule*: “Do not do to others what you do not want done to yourself.”

Confucius preached the idea that society should be self-regulating through the advancement of education, persuasion, and virtue, and not by the force of law. Thus, the guiding force for social and economic relationships was the *li* (moral values). In contrast, beginning with the *Qin* Dynasty (221–206 BC), the importance of clear, formal legal rules or *fa* became more valued. But Confucianism remained the state ideology into the twentieth century.

A legal code writing tradition began with the *Qin* and *Han* Dynasties. However, these early legal codes were largely limited to harsh criminal laws. The more comprehensive and meaningful code was the **Tang Code** of the seventh century AD. Code writing culminated with the 1740 **Great Qing Code**, which consisted of 436 statutes and about 1,900 sub-statutes. These indigenous dynastic codes set the basis for the categorization of China as a civil law system. This continues to the present, as China has recently committed to enacting a comprehensive civil code along the lines of the grand civil codes of Europe. As will be seen in the coverage on Hong Kong, the “laws” of China are mixed, with Mainland China’s law based on laws enacted in the 1980s to the present, Hong Kong follows English common law, and Macau’s law is rooted in Portuguese civil law. See Chapter 10’s coverage of “Comparative Legal Systems.”

Company and Corporation Law

There are many more approvals needed in order to form a company in China than in the U.S. The process takes at least a month. The **Company Law of the People’s Republic of China** of 1993 was based largely on the company laws of Taiwan, France, Germany, and Japan. The **New Company Law** of 2006 is particularly important because it relates to foreign investment in China (establishment of businesses and manufacturing plants). Chinese foreign investment law requires that operations by foreign investors be conducted through a **Chinese Limited Liability Company**.⁴ In doing business with Chinese companies it is important for the foreign investor to verify their ownership of property that it seeks to purchase. This is shown in the *Apple v. Proview* case study discussed below.

Property Law

American businesspeople in China must understand the history and extent of private property rights in China. The number of required administrative approvals to obtain property can be frustrating for a Westerner anxious to do business in China. On October 1, 2007, a **New Property Law** went into effect. Article 3 of the law shows the confusing nature of property law in China since it blends the concept of communal ownership (socialism) with the private property rights found in a market economy:

In the primary stage of socialism, the State upholds the basic economic system under which public ownership is dominant and allows the economic sectors of diverse forms of ownership to develop side by side. The State consolidates and develops the public sectors of the economy, and encourages, supports and guides the development of the non-public sectors of the economy. The State maintains a socialist market economy and guarantees the equal status and the right to development of all the mainstays of the market.

The real property law has separate provisions for immovable property (land and buildings) and movable property (goods or materials). All land is technically owned by the State or by a collective. Collectives are

A seemingly IP law issue became an issue of corporate law in a dispute over the ownership of the “iPad” trademark. Proview Shenzhen registered a trademark in China for something called IPAD long before Apple began producing its world famous iPad. Apple had to make a strategic decision to bring a lawsuit to force the assignment of the trademark to Apple or to negotiate for the voluntary assignment of the trademark. It chose the latter approach and negotiated an assignment agreement for the price of 35,000 British pounds with UK Proview (parent company) and its Taiwan subsidiary (Taiwan Proview). To Apple’s surprise the trademark was held by another Chinese subsidiary called Proview Shenzhen. The issue was whether the trademark assignment agreement was binding on Proview’s mainland subsidiary. Article 3 of **Chinese Corporate Law** states that “a company is an *enterprise legal person*, which has independent property of a legal person and enjoys the property rights of a legal person.”

The independence of a company from related or affiliated entities is referred to as **personality confusion**. In such cases, the Chinese court will weigh the following conditions between corporations: (1) asset confusion, such as combined funding and mixed financial management; (2) business confusion, such as the overlap of business scope or business crossings; (3) labor

and personnel confusion, such as joint legal representative, senior management, or the bilateral employment of the employees; and (4) the confusion of the place of business. Under the current case, the China mainland subsidiary and the Taiwanese subsidiary are financially, operationally, managerially, and geographically separate entities. Moreover, there are no controlling shareholders common between the two companies. Therefore, there is little personality confusion between the two companies, and therefore Apple was not likely to win its lawsuit that Proview Shenzhen was obligated to assign its right to IPAD. Apple made the rational decision to negotiate with Proview Shenzhen at a reasonable cost instead of pursuing long-term litigation that it would eventually win. On July 2, 2012, Guangdong Higher People’s Court announced that the trademark dispute involving Apple, Inc. had been settled through mediation. Apple agreed to pay \$60 million to Proview Shenzhen for assignment of IPAD trademarks registered by Proview Shenzhen in China. This was a small cost given the size of the Chinese market for iPads. This case demonstrates the importance of ownership and the value of IP rights. Foreign companies must be familiar with Chinese business law and perform adequate due diligence to understand law and practice, and locate the true owner of a particular right.

Figure 9.4 Case Study: Apple v. Proview.

found mostly in the rural areas. Article 8 of the **Land Administration Law** states that the land in the urban areas is owned by the State, while “land in rural and suburban areas is owned by *peasant collectives*.” For example, a village may control the surrounding farmland as a collective. In more urban areas, private entities petition the government for a **right to use** the land. So a development company first obtains a right to use land to construct an apartment or condominium building. Upon completion, buyers of the individual units obtain a right to use the unit for a period of time. For the owner of a home or apartment, the right to use (ownership) is a maximum of 70 years. The law also allows for the renewal of the right to use, but is silent as to whether the renewal would be for another 70 years or less. It is also silent as to whether the “owner” would have to pay a fee for the renewal. The right of use for commercial property (manufacturing plants, stores, warehouses, and so forth) is 50 years. The right to use land for farming, owned by a peasant collective, is a period of 30 years. However, land contracted out for 30 years may be reclaimed and reallocated upon a two-thirds vote of the village assembly, subject to the approval of the town government and the agriculture department of the county government.

In the case of apartment-condominium buildings, Article 76 of the Property Law requires only a majority vote of the unit owners for most matters involving the management of the building. However, in two cases a supermajority is required—raising or using funds for the maintenance of the building and renovation of the building. In those cases, two types of supermajority votes are required: (1) two-thirds of the ownership of the square meters of the individual units and (2) two-thirds or more of the total number of unit owners.

Since there is no such thing as 100 percent ownership in real property (common law’s *fee simple* or absolute ownership), there are no such ownership documents, such as a deed. In place of the recording of a deed, the 2007 Property Law created a uniform **Real Property Registry**. It is very important to register the **Certificate of the Right to Use** as quickly as possible. If a property is sold to more than one person, the first one to register is deemed to be the owner. The land registry is conclusive evidence of ownership. In fact, any contract affecting real property should be registered immediately. For example, a contract to lease some office space should be recorded in the Real Property Registry.

Chinese Contract Law

China's transformation into a market economy and ascendancy into a global economic power increases the importance of the study of its private laws (contract, torts, and property). The twin pillars of a market economy are private property and contract law (the ability to transfer private property). The evolution of Chinese contract law provides an opportunity to study the influences of foreign laws and the formal **transplantation** of foreign and international law into a different cultural and legal tradition. Legal transplantation (so named by Scottish-American legal scholar Alan Watson in his 1974 book entitled *Legal Transplants*) means the moving of a legal rule, a law, or an entire system of law from one country to another. Transplantation is also referred to as the *reception* of foreign law. The most dramatic example was Europe's reception of Roman law. China's development of a private contract law, beginning in the mid-1980s, is very interesting because of the breadth of the foreign law influences involved in that development. However, the variety of sources used by the drafters of the **Chinese Contract Law (CCL)** has had unintended consequences. The CCL possesses a number of "gaps" and inconsistencies because of the variety of influences and partial transplantations used in its drafting.

The People's Republic of China has gone through a series of receptions and legal transplantations from foreign or international private laws since it began in earnest, during the 1980s, to transition from a planned to a market economy. In order to facilitate trade, it adopted the Foreign Economic Contract Law of 1985 (FECL) to assure foreign parties that a modern contract law would apply to their transactions. It was written in the style of a Western civil code. In 1988, China became an original signatory to the United Nations Convention on Contracts for the International Sale of Goods (CISG). Again, it demonstrated China's willingness to follow Western-style contract law, as well as its foresight of seeing the benefits of a uniform international sales law to an emerging economy. In addition, it adopted the Technology Contract Law in 1987. In 1999, China elected to harmonize its domestic and foreign contract laws. The FECL was repealed and a uniform national law was enacted—the CCL. The analysis here is on the contract law of Mainland China as represented by the CCL.

Thus, in a short period of time China had received or enacted a series of Western-style contract laws—FECL, CISG, and the CCL. It was inevitable that problems would appear in adopting foreign law due to a number of factors: (1) problem of translating foreign legal concepts, principles, and rules from one language to another; (2) problem of introducing a new foreign legal regime into existing domestic legal and cultural traditions; (3) problem of interpreting the words of a new law; and (4) introducing a foreign text into a country without an existing body of jurisprudence or expertise to properly and consistently apply the new law.

The more successful of the receptions was China's adoption of the CISG. One reason for this is the wealth of international case law and commentaries that Chinese legal bodies have been able to use in applying CISG's provisions. Currently, there is no hard evidence of whether or not the Chinese courts have adeptly applied the CISG in a consistent way. However, there is strong evidence that Chinese arbitral bodies have successfully done so. There are about 400 published decisions (in English) from China's premier arbitral body, the CIETAC. The CIETAC awards have generally been well reasoned and of high quality, showing its ability to understand and properly apply the CISG in an unbiased manner.

Current Chinese commercial laws reflect the influence of European civil laws, especially German law influences, and to some extent they have been influenced by the common law. The problem of legal transplants is that the text of law is easily movable from one country to the next, but legal tradition, legal reasoning, and legal theory is not so easily transplanted. Professor Shiyuan Han has made such a case in the area of pre-contractual liability. China adopted the doctrine of *culpa in contrahendo* or bad faith negotiations, which is found in civil law. The important point that Han makes is that the ability of the Chinese courts to understand and apply such a concept depends on what he calls "theory reception." A law of pre-contractual liability is more than a set of fixed rules; it is based upon a broad theory of good faith.

CCL reflects a myriad of influences from the civil law (especially, the German Civil Code), the common law, and the American Uniform Commercial Code, as well as international legal instruments, such as the CISG and the

UNIDROIT Principles of International Commercial Contracts (PICC). In this case, the study and use of these multitude of foreign and international laws by the drafters of the CCL, although admirable, has resulted in less than a clear and comprehensive contract law. This has caused substantial confusion in the Chinese courts in applying its rules in a uniform manner.

Intellectual Property Law

In November 2011, China and the United States reached several important agreements covering intellectual property rights at the 22nd **U.S.–China Joint Commission on Commerce and Trade (JCCT)**. The State Administration for Industry and Commerce (SAIC) is the authority in charge of enforcement against online counterfeiting. More recently, China authorized the creation of special courts to hear Intellectual Property Rights (IPR) claims, with specialized training in IPR law (trademark, copyright, patent rights). Chapter 18 on the “Law of Intellectual Property Rights” and Chapter 19 on “Intellectual Property Licensing” will cover IPR in depth.

China has become famous for producing counterfeit goods in violation of IPR. The common way of dealing with this problem is to punish the offending country with trade sanctions through the WTO or unilaterally through U.S. trade law. Due to the size of the Chinese consumer market, foreign companies have been willing to continue to do business there despite inadequate IPR protections. IPR owners have had to take innovative methods to reduce the infringement on their rights. One method has been the creation of **Brand Protection Units** that work with local police authorities to raid the operations of counterfeiters. Figures 9.5 and 9.6 gives a few other real world examples of proactive non-sanction-based methods of combatting illegal counterfeiting.

Apple asked China’s State Intellectual Property Office (SIPO) to invalidate a voice recognition patent owned by Zhizhen for “Xiao i Robot.” LA Patent Review Committee under the SIPO and Beijing No.1 Intermediate People’s Court, in September 2013 and July 2014, respectively, rejected Apple’s complaint that Zhizhen infringed on the copyright for Siri. Siri is a technology developed by Apple to allow its customers to create a “personal assistant” through voice recognition software. Apple was not aware of Zhizhen’s patent before it introduced Siri and argues that Siri does not infringe on Zhizhen’s.

Apple appealed in its counterclaim against Zhizhen and China’s SIPO. In April 2015, Beijing Higher People’s Court upheld Apple’s appeal, ordering the Chinese agency to reverse its decision. The Court held that Apple’s Siri voice recognition system did not infringe on Zhizhen’s patent. Subsequently, Zhizhen filed an appeal with China’s Supreme People’s Court over the disputed patent. If Zhizhen wins the case, Xiao i Robot can block the usage of Siri in China, but if it fails, Zhizhen will also benefit from the case due to the publicity.

Case of Good Citizen Company

One American company faced with losing market share to piracy of their products took unilateral actions to change the local community’s and police officials’ attitudes toward the counterfeiters. First, the company announced a long-term commitment to the community and the selling of its products in China. Second, it committed to reinvest its profits in the country, donated to local charities, localized their management team through local training programs, and began using local suppliers. All these efforts were well publicized by the company in local media outlets. Eventually, the rate of piracy and counterfeiting of their goods decreased dramatically as local residents cooperated with the police who undertook more aggressive enforcement efforts.

Case of Quality Products

An American company that produced food products paid reporters to observe raids on counterfeit operations to show the shoddy and unhealthy conditions of the manufacturing operations. The publicity tarnished the image of the counterfeiter’s products and provided positive publicity to the officials that conducted the raids. The company then publicized the unhealthy and unsafe nature of the counterfeited products due to the unsanitary conditions at the factories in which they were produced. This marketing campaign stressed concerns for the safety of children and portrayed the raids as consumer protection efforts. The company used the traditional Chinese cultural sanction of “shame” to reduce the marketability of the counterfeited goods.

Figure 9.5 Protecting IPR in China: Examples from the Field.⁵

- | | |
|-----------------------------------------------------------------------------------|--------------------------------------------------------------------------------|
| 1 Register your IP rights with Chinese authorities and secure management control. | 6 Explore uniform pricing. |
| 2 Assign responsibilities for internal IPR security. | 7 Police inventory. |
| 3 Use direct sales and design outsourcing. | 8 Educate consumers. |
| 4 Audit licensing and distribution contracts, and manufacturing partners. | 9 Make allies with local officials and domestic companies (such as retailers). |
| 5 Install tracing and labeling control systems. | 10 Avoid lawsuits by dealing directly with counterfeiters. |

Figure 9.6 Ten Strategies for Fighting IPR Infringement in China.

Another problem in China has been bad faith filings (also referred to as “trademark squatting”), where the authorities have taken a tolerant approach. However, the problem of trademark squatting has also attracted substantial attention from the Supreme People’s Court. The Supreme People’s Court has called for the full exploitation of current laws in order to curb bad faith trademark filings.

Investment Law

In the area of investor protections, China and, to a lesser extent, Russia have been open to provide protections to foreign investors through BITs. Historically, BITs were aimed at protecting investments from industrialized or developed countries in the developing countries. The first BIT was signed in 1959 between Germany and Pakistan. The first modern investment treaty would be the 1969 Italy–Chad BIT—the first to combine substantive investment protection with binding investor-country arbitration at the **International Centre for Settlement of Investment Disputes (ICSID)**.

More recent investment agreements with Germany, ASEAN, New Zealand, Chile, and Canada show China is updating its investment protection standards. The World Bank rankings of FDI inflows ranked China first with \$389 billion of inward investment in 2014. The Chinese model BIT is closely aligned with the texts developed by the British and Germans, with a third generation BIT produced in 1997. Along with actively pursuing BITs in the 1980s and 1990s, China became a party to the **Multilateral Investment Guarantee Agency Convention (MIGA)** and signed the **ICSID (Investor-Country Arbitration) Convention** in 1999. Still, four of the top ten investors in China—Hong Kong, Taiwan, U.S., and Macau—do not enjoy investment protections.

China has pursued a two-tier BIT policy. BITs with developed countries primarily served the purpose to build economic infrastructure through inbound investment, especially to secure acquisition or control of technology and other advanced skills. Conversely, BITs with developing countries, especially in Southeast Asia and Africa—whose text usually coincides with the Chinese model—were primarily aimed at forging or strengthening diplomatic alliances, and to obtain access to resources to satisfy energy demands.

The importance of investor protections to the Chinese has increased with the trend of large outward investments by the Chinese. The United Nations Conference on Trade and Investment (UNCTAD) calculated that 2014 FDI Outflows totalled \$1,354,046 billion with Asia at \$431,591 billion; United States at 336,943 billion; European Union at 280,124; Latin American including South America at 23,325 billion; and Africa at 13,072 billion. Thus Asian investments in the world made up of 31.9% of all world FDI. Currently, China has 94 active BITs, along with five free trade agreements, compared to Brazil with no active BITs, Russia with 54 active BITs, and India with 68 BITs, while South Africa has entered into 23 BITs. However, Brazil refuses to negotiate new BITs, South Africa is attempting to terminate existing BITs, and India has frozen current BIT negotiations pending approval of a new model BIT.⁶

China’s transformation into an investor country (outward investment) is reflected in China’s adoption of a more flexible approach. By the same token, China’s foreign investment protection program (inward investment) has been undergoing gradual yet major changes, in terms of structure and wording. The investment protections incorporated in China’s agreement with Germany (2003), Pakistan (2006), New Zealand (2008), ASEAN (2009), Peru (2009),

Canada (2012), and Chile (2012), all displayed China's increasing concern with the protection of its own investment abroad. It has increasingly placed reliance on the North American models of protection of foreign investments.

Joint Venturing in China

A joint venture is a business arrangement in which the participants create a new business entity or official contractual relationship and share investment and operation expenses, management responsibilities, and profits and losses. The Chinese government encourages foreign investors to use this form of company in order to obtain advanced technology. In return, foreign investors obtain low labor costs, low production costs, and access to the Chinese market. After a joint venture is registered, the entity is considered a Chinese legal entity and must abide by all Chinese laws.

However, unlike most countries, this strategy is not simply a matter of two companies negotiating and entering into a joint venture agreement. The joint venture must obtain the approval of various agencies of the Chinese government. The controlling law is the **Sino-Foreign Equity Joint Venture Enterprise Law (EJV)**. The EJV provides the following five grounds for the rejection of the formation of a foreign joint venture:

- damage to Chinese sovereignty;
- violation of Chinese laws;
- noncompliance with the requirements for the development of China's economy;
- cause of environmental pollution;
- obvious unfairness in the joint venture agreement.

These prohibitions are unusually vague, giving Chinese authorities wide discretion in rejecting foreign joint ventures in China. The prohibition with the most practical importance is the "unfairness of the joint venture agreement." This gives Chinese authorities the power to review the terms of the joint venture agreement. Thus, a foreign party must obtain the approval of the **Ministry of Commerce (MOC)**, as well as the need to obtain approval of provincial and municipal governments where the joint venture is to be located.

The approval process includes the submission, in the Chinese language, of an application; feasibility study; the joint venture agreement and the articles of association; and a list of the officers of the joint venture. The government agencies must approve or disapprove the joint venture within three months, or they can prolong the process by asking for amendments to the documents. Upon receiving a **Certificate of Approval**, the joint venture then has one month to register with government authorities and obtain a business license. In addition, any licensing or transfer of technology must receive separate approval of the government authorities. This review is intrusive in that it may require changes in the licensing agreement to make it more favorable to the licensee. Article 43 states that the agreement must meet the following criteria: royalty fees must be fair and reasonable, no restrictions on the export of goods using the technology, duration of license is not to exceed ten years, after the expiration of the license the Chinese parties may continue to use the technology, any improvements made to the technology shall be shared between the parties, the licensee shall obtain materials and components from any source it deems appropriate, and "any unreasonable and restrictive clause" prohibited by Chinese law is invalid.

A second law was also enacted called the **Sino-Foreign Cooperative Joint Venture Enterprise Law**. Unlike an equity joint venture, where the foreign party has an ownership interest in the joint venture, a cooperative joint venture is an agreement to cooperate and invest in a joint project, such as the manufacture of goods for export. Both joint venture laws do provide limited liability protection so that the investment of the foreign party is the extent of its liability. The cooperative joint venture must have a board or directors or a joint management committee. Unlike the equity joint venture, the duration of the cooperative joint venture is determined solely by agreement of the parties. For excerpts of the Law on Chinese-Foreign Joint Ventures, see Figure 9.7. Figure 9.8 provides "Tips on Managing Chinese Joint Ventures."

Article 1: China permits foreign companies (foreign partner in joint ventures) to join with Chinese companies (Chinese partner in joint ventures) to establish joint ventures in accordance with the *principle of equality and mutual benefit* and subject to approval by the Chinese government.

Article 2: China shall not *nationalize* or take over joint ventures; under special circumstances and according to the needs of social public interests, the state may requisite joint ventures according to legal procedures with due compensation.

Article 3: The joint venture agreement, contract, and articles of association signed by the parties to the venture should be submitted to the competent Chinese (examining and approving organ) for *examination and approval*; the approving organ shall, within three months, decide whether to approve or disapprove the joint venture. After approval, the joint venture should register with the competent administration department for industry and commerce and to obtain a license to do business.

Article 4: A joint venture shall take the form of a *limited liability company*. The proportion of the investment contributed by the foreign joint venture partner should generally not be less than *25 percent* of the registered capital of a joint venture. The parties to the venture shall share the profits, risks, and losses in proportion to their respective contribution to the registered capital.

Article 5: Each party to a joint venture may make its investment in cash, in kind, or in industrial property rights. The technology and the equipment that serve as the investment of the foreign partner in a joint venture must be *advanced technology* and equipment that actually suits China's needs. If the foreign partner in a joint venture causes losses by deception through the intentional use of

backward technology and equipment, it shall pay compensation for these losses.

Article 6: The chairman of the *Board of Directors* shall be a party from one side of the venture and vice-chairman a party from the other party. The board of directors shall decide major problems of the joint venture in accordance with the principle of equality and mutual benefit.

Article 7: Joint ventures shall provide necessary conditions for the activities of the *trade unions* within the enterprises.

Article 8: A foreign partner in a joint venture that reinvests in China its share of the net profit may apply for refund of a part of the *income taxes* already paid.

Article 9: A joint venture shall open a *foreign exchange account* with a bank approved by the state foreign exchange administration. The pertinent foreign exchange transactions of a joint venture shall be conducted in accordance with the regulations on foreign exchange control of China.

Article 10: In its purchase of required raw and processed materials, and fuels within the approved business scope, a joint venture may make the purchases from Chinese market or the international market according to the principle of being fair and rational. A joint venture is encouraged to market its products outside China. *Export products* may be distributed to foreign markets through the joint venture directly or through associated agencies, and they may also be distributed through China's foreign trade agencies.

Article 13: If the parties to a joint venture with a prescribed *duration* or contract period agree to extend the period, an application for extension of the contract should be made six months before its original expiration date. The examining and approving organ should make a decision within one month from the day of receiving the application.

Figure 9.7 Excerpts from 2001 Law on Chinese–Foreign Joint Ventures.

Seeking Alternatives: Because of the risks, joint ventures should not be entered unless necessary. An alternative is the Wholly Foreign-Owned Enterprise (WFOE); however, WFOEs are prohibited in certain economic sectors.

Long-Term Consequences: Joint venture partners are often potential competitors. A long-term risk that needs to be guarded is the risk of sharing confidential information with a joint partner, eventually allowing them to enter the market as a competitor. It is also prudent to require a noncompetition agreement with the Chinese partner.

Due Diligence: It is important to investigate your potential joint venture partner in regards to reputation, bribery, and anticorruption policies and any track record of regulatory noncompliance.

Technology Transfer: As a practical matter, technology should be segmented and distinguished so that the complete core technology is not exposed. If possible, the critical core technology should be embodied in components or materials produced else-

where and supplied to the joint venture by the foreign party. Technology transfer or licensing contracts (between the foreign party and the joint venture) should end at the same time as the joint venture agreement. Also, all key employees of the joint venture should be subject to confidentiality and non-compete agreements. All trademarks, including company and brand names, of the foreign joint venturer should be registered with Chinese authorities before beginning negotiations with any Chinese companies.

Exit Strategy: Chinese law does not allow a party to a joint venture to unilaterally terminate the agreement. Therefore, the joint venture agreements should provide a list of events, such as failure to meet certain sales levels or management deadlock that would automatically create a right to terminate the joint venture. The agreement should also make it clear that termination of the joint venture also terminates provisions in the technology transfer and licensing contracts.

Figure 9.8 Tips on Managing Chinese Joint Ventures.

Franchise Law of China

China continues to revise its franchise law.⁷ In February 2005, the Chinese Ministry of Commerce and the State Council enacted the first comprehensive regulations on franchising. Unfortunately, in the area of disclosure,

Article 19(2) of the franchise regulations vaguely states that the franchisor is required to disclose the “number, location, and operational results of its franchisees.” It is still to be determined whether this requires the franchisor to provide information on potential sales and the average sales at existing locations. However, in the updated 2007 **Law on Franchise Regulations**, Article 22(8) provides that the franchisor must provide enough information in order for a prospective franchisee to “evaluate” the “operational results or status.” The word “evaluation” imposes an “enhanced disclosure duty on franchisors, because franchisors are required not only to disclose the numerical data about the sales of the existing franchisees in China, but also to provide a prediction as to the potential sales of the (proposed) franchise.”⁸

In 2007, the State Council also adopted the **Regulations on the Administration of Commercial Franchise**. It completes the process of recognizing franchising as a legal structure and business model in China. The 2007 Regulations apply to domestic franchisors and franchisees and to foreign franchisors. The Regulations’ single set of rules replaces the different sets of regulations for domestic and foreign companies. The law requires that the franchisor must make specific disclosures to provide franchisees, by providing operational handbooks, with long-term guidance, technical support, training, and other services. It also includes substantial penalty provisions for noncompliance.

The new Regulations also provide franchisors greater freedom of contract to insert stronger protective clauses in the franchise agreement. The new Regulations remove the three-year minimum for a party to declare a default if the parties agree to terminate the franchise. It allows the parties to decide on the length of the franchisee’s right of rescission (termination). The new Regulations allow the parties to allocate products liability. Under the previous law, the franchisor and franchisee were *jointly and severally liable*. It also expressly allows a clause that requires franchisor’s consent to the assignment of the franchise and for a change of location. The **China Chain Store Franchise Association** has been given the authority to prepare and issue more detailed policies, guidelines, and rules to clarify the 2007 Franchise Regulations. It can now be said that China has a modern franchise law that makes it easier for foreign franchisors to enter the Chinese market.

Administrative Law

Administrative law relates to government regulations and the government’s enforcement of those regulations. If a company or person believes it has been improperly fined, denied government permits or approvals, or has been subject to an enforcement action, it may want to contest those decisions. Oftentimes the basis for the dispute is a government agency’s interpretation of a law. The company or person subject to that interpretation may argue that the agency’s interpretation of a statute was in error. Other grounds to contest a government action are misconduct of government officials, such as undue delay in rendering a decision, a permit, license, or approval required under law. In most countries, regulatory decisions must first be disputed internally, before proceeding to a court action. For example, the U.S. Internal Revenue Service provides administrative procedures that must be used and exhausted before a taxpayer may bring a claim to court (litigation). In China, the law provides that a party may pursue administrative relief or proceed directly to litigation. If a claimant pursues administrative relief, or what is called *administrative reconsideration*, it may be precluded from pursuing a remedy in the court system.

One problem that Chinese administrative law presents is its obsolescence. The basic **Administrative Litigation Law (ALL)** was enacted in 1989 and has not been updated despite its numerous shortcomings. The lack of amendments or updating of the ALL is unusual because initial laws have been commonly updated as China has transitioned to a more advanced market economy. One scholar offers this reason: “It shows the lack of consensus among political elites to improve legislation used to pursue a higher level of protection of citizens’ rights and supervision of government institutions to ensure their functioning within the framework of legal constraint.”⁹ In order to contest a government or agency decision in court, a claimant is confronted with a number of problems: (1) difficulty of getting a court to accept the complaint, (2) difficulty in receiving a decision from the court within a reasonable period of time, and (3) the difficulty in enforcing the judgments of the court.¹⁰ Because of the lack of statutory amendments, much of administrative law is found in the judicial

interpretations of the Supreme People's Court, along with published commentaries issued by the Court, such as the **Explanations on Several Issues Concerning the Implementation of Administrative Litigation Law** issued in 2000.

Unlike the ALL, the 1990 **Administrative Reconsideration Law (ARL)** was replaced in 1999. Administrative Reconsideration allows a party to appeal the decision of a government official or government body to a higher level of the administrative agency. In practice, about 70 percent of cases avoid administrative reconsideration and proceed immediately to the courts. However, there are a number of exceptions to the right to litigate. In some cases a party must first pursue administrative reconsideration before being allowed to file a judicial claim. This includes disputes over the ownership of natural resources, tax disputes, competition (antitrust) actions, and trademark disputes (validity of trademark). Also, administrative reconsideration decisions are final (no right to appeal to a court) when issued by the State Council. A more rational process would mimic the U.S.; administrative appeals must first be used. Following the exhaustion of administrative procedures, there is an absolute right to appeal to the courts the final administrative decision.

A party's ability to pursue a lawsuit requires that there be a **concrete administrative action**. Concrete actions include: the assessment of administrative penalties, fines, revocation of business licenses or permits, orders suspending business operations; seizure or freezing of property; infringement on the management of a business; refusal to reply to an application or request for a permit or license; and infringement on property rights.

Despite the difficulties of bringing litigation against a government agency, there has been a proliferation of lawsuits of all types over the last twenty years. In 1991, there were about 25,000 cases of administrative litigation, in 2001 there were 96,000 cases, and in 2011 there were 136,000 cases. Commercial and civil litigation has proliferated from two million case filings in 1988 to more than 6.5 million case filings in 2011.¹¹ There a number of reasons for this explosion in litigation: (1) the conversion from a communist to a market economy, and the subsequent passage of numerous substantive laws, have provided persons and companies rights that they did not previously possess; (2) there has been a cultural shift from viewing litigation as dishonorable to it being a way of protecting a person's rights (move from a status-relations based society to a transactional society); and (3) legal education and the professionalism of judges is much improved.

A controversy has developed over the overuse of mediation (*tiao je*) or reconciliation (*he jie*) in the litigation process. This is an issue that applies to all forms of litigation but is especially problematic in administrative litigation. A 2007 Supreme People's Court's **Opinion on the Positive Roles of Litigant Mediation in Constructing Socialist Harmonious Society** encouraged mediation throughout the litigation process (pretrial and during the trial). The problem is that the courts, especially in administrative litigation, are hesitant to rule against government authorities and use mediation to avoid making a decision, and to prolong the litigation process. In this regard, mediation is used as a coercive device (either settle or wait a long, long time for a decision). Chinese lawyers have created a set of terms that prove the point: *yi ya cu tiao* (mediation by coercion), *yi pan ya tiao* (veiled threat that court's decision will be worse than a mediated outcome), and *yi you ya tiao* (delaying of decision to coerce mediation). In sum, the ALL and ARL have advanced China's evolution into a modern legal system. The image of the government official as being above the law—"officials are dignitaries and citizens are humble"—has been destroyed and replaced with the principle that citizens have the right to sue their government.¹² However, obtaining a remedy against the government is difficult because of a lack of judicial independence, especially in administrative law matters where administrative agencies are considered more powerful than the courts.

Communist Party

Even though foreigners doing business in China obtain approvals and licenses from the government, it is important to realize that the real power in China resides in the **Communist Party (Party)**. The structure of the Party is a mirror image of the structure of the Chinese government. At the national level power resides in the NPC, **Central Committee**, and the **Politburo**; at the provincial level there are provincial committees of the Party, and so forth, through the levels of municipal, county, and village government. The highest power in government, along with the

President, is the Central Committee. But a more concentrated place of power within the Central Committee is the Politburo (Political Bureau), which has between 14 to 24 members. However, the most elite group is the Politburo Standing Committee or **Standing Committee** made up of four or five members.

The Party is a political and not a governmental agency. However, the Party controls every facet of government and society. Membership in the party is needed to advance in government, academia, business, and many other professions. The NPC meets once every five years. The Central Committee organizes an annual plenary session generally consisting of a few thousand delegates chosen by the Committee. Again, power ultimately resides in a smaller group of four to five members of the Standing Committee. See Figure 9.9 on the “Communist Party Structure.”

As noted above, the Party is a hierarchical system of concentrated power duplicated at the provincial and local levels of the country. The system extends to the level of local organizations (*danwei*) in the factories, and workers in companies, farms, townships, villages, as well as school and neighborhood organizations, must have at least three members from the Party. Each of the *danwei* must have a primary Party committee, which then answers to a larger and higher level Party committee (*danwei* with more than 100 Party members). The purpose of these committees is to act as a conduit between the people and the Party by promoting Party ideology, recruiting new members to the Party, and to provide information to the Party as to day-to-day activities of the people. So it is obvious that the Party influence reaches to the lowest levels of society.

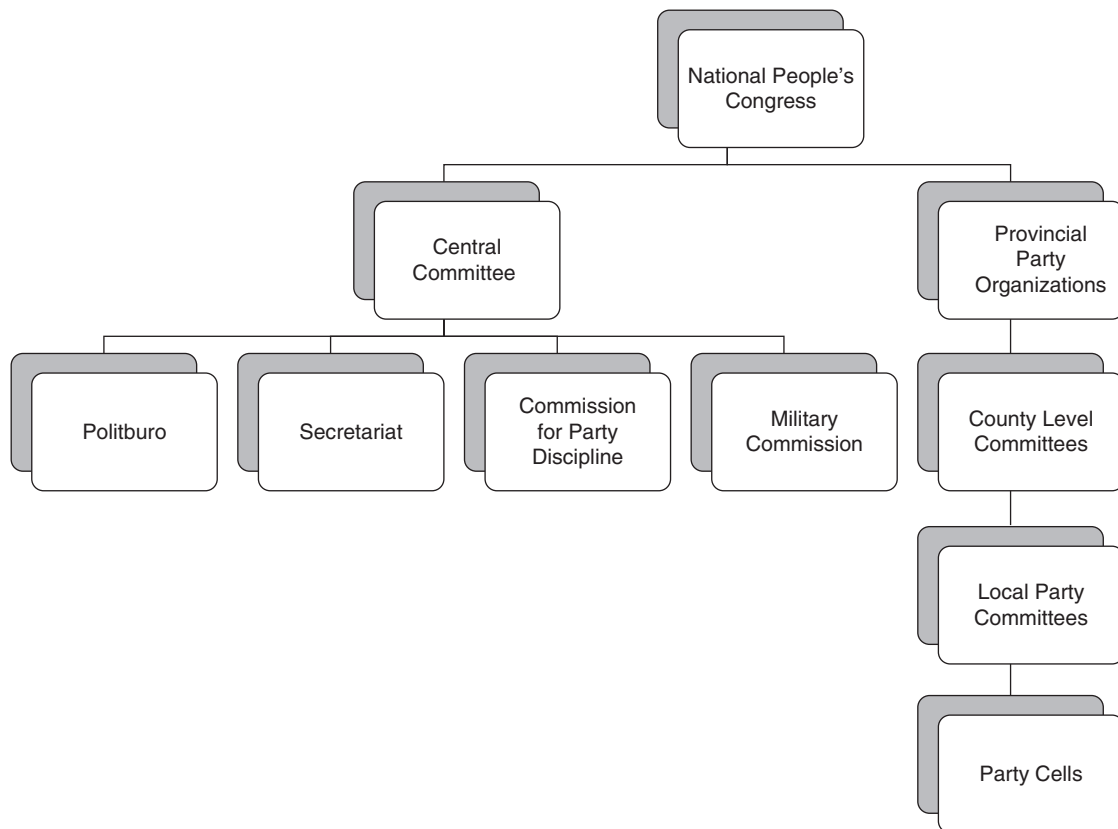


Figure 9.9 Communist Party Structure.

The Party controls the government by creating lists of Party members used to fill government positions. This is known as the **nomenklatura system**. Again, as was shown in the party organizational structure discussed above, the nomenklatura system is replicated throughout the different levels of government. Thus, the Central Committee creates lists of candidates for national level government positions including appointments to all ministries of the government, as well as for appointments to the People's Supreme Court. At the lower levels of government, the Party committees create government positions and lists of those "qualified" to fill those positions. The Party acts in the background of the formal governmental structure and exercises power by its control of government positions through the nomenklatura system.

Back to Business: China's Competitiveness

As in all economies, especially in lesser-developed countries, there is a unique mix of strengths and weaknesses. This section reviews China's competitiveness in the world economy and highlights its weaknesses. For China to transition to the highest stage of economic development (innovation-driven economy) it will need to address these weaknesses. Figure 9.10 provides the evidence of China's ascendance to a world economic power by showing its share of world exports and imports.¹³

In order to examine Chinese strengths and weaknesses, the **World Economic Forum's** ranking and competitiveness analyses of China will be used. The World Economic Forum's rankings are based upon analysis of the **Twelve Pillars of Competitiveness**, which include: Institutions, Infrastructure, Macroeconomic Environment, Health and Primary Education, Higher Education and Training, Efficient Goods Market, Labor Market Efficiency, Financial Market Development, Technological Readiness, Market Size, Business Sophistication, and Innovation. Each of the Pillars can be studied in more detail by reviewing the numerous criteria used within each Pillar to rank countries on that specific dimension of competitiveness.

Competitiveness is closely tied to a country's level of development. The World Economic Forum provides a typology of three stages of development: **factor-driven economies** (primarily unskilled labor and natural resources), **efficiency-driven economies** (more efficient production processes), and **innovation-driven economies** (higher wages; creation of new and unique products). Factor-driven economies generally have established the first four Pillars; efficiency-driven economies rely on Pillars five through ten; and innovation-driven economies have soundly established competencies in Pillars 11 and 12. China is rated as a factor-driven economy, while Brazil and Russia (prior to Ukraine crisis) are rated as countries transitioning from factor-driven to innovation-driven economies, and India remains a factor-driven economy. Hong Kong SAR is rated as an innovation-driven economy. The schematic showing the Twelve Pillars of Competitiveness and the three stages of economic development are shown in Figure 9.11.

The Global Competitiveness Index 2014–2015 rankings and 2013–2014 comparisons show China as the 28th or 29th most competitive country out of 144. It scored a 4.89 on the overall competitiveness on a scale of 1 to 7. The three most competitive countries and their scores include: Switzerland (5.70), Singapore (5.65), and the U.S. (5.54). Hong Kong was ranked 7th with a score of 5.46. Table 9.1 shows China's rankings (out of 144 countries) and scores on each of the "Twelve Pillars of Competitiveness." The next few sections will review some of the Pillars of Competitiveness as they relate to China.

<i>Share of World Imports (2013) (%)</i>		<i>Share of World Exports (2013) (%)</i>	
U.S.	15.9	EU	16.0
EU	15.2	China	15.4
China	13.3	U.S.	11.0
Japan	6.1	Japan	5.7
South Korea	3.5	South Korea	3.9
Canada	3.1	Russia	3.7

Figure 9.10 Share of World Imports-Exports.

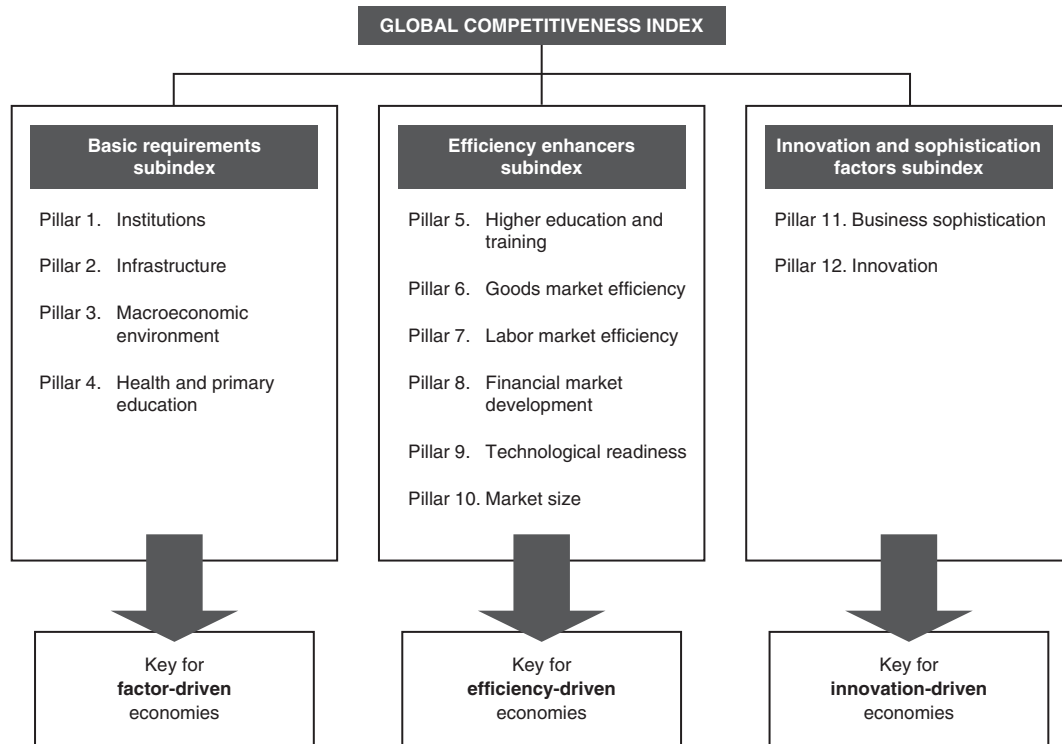


Figure 9.11 Global Competitiveness Index.¹⁴

(World Economic Forum).

Institutions

Under the Global Competitiveness Index China ranks 50th on property rights, 53rd on intellectual property protection, 60th on judicial independence, 66th on corruption, 49th on efficiency of legal system in dispute resolution, 82nd in auditing and accounting standards, and 83rd on investor protections. Surprisingly, the burden of government regulation ranks 19th in the world. The legal and administrative framework within which individuals, firms, and governments interact to generate wealth determines the strength of the institutional environment. The importance of a sound and fair institutional environment became all the more apparent during the 2008 economic and financial crisis and is especially crucial for the ability to recover from such events.

The quality of institutions has a strong bearing on competitiveness and growth. It influences investment decisions and the organization of production and plays a key role in the ways in which societies distribute the benefits and bear the costs of development strategies and policies. For example, owners of land, corporate shares, or intellectual property are unwilling to invest in the improvement and upkeep of their property if law does not protect their rights as owners.

The role of institutions goes beyond the legal framework. Government attitudes toward markets and freedoms and the efficiency of its operations are also very important: Excessive bureaucracy and red tape, overregulation, corruption, dishonesty in dealing with public contracts, lack of transparency and trustworthiness, inability to provide appropriate services for the business sector, and political dependence of the judicial system impose significant economic costs to businesses and slow the process of economic development.

Although the economic literature has focused mainly on public institutions, private institutions are also an important element in the process of creating wealth. The global financial crisis, along with numerous corporate

Table 9.1 China and the Twelve Pillars of Competitiveness

<i>Pillar</i>	<i>Ranking out of 144</i>	<i>Score (1–7)</i>
Institutions	47	4.2
Infrastructure	46	4.7
Macroeconomic Environment	10	6.4
Health and Primary Education	46	6.1
Pillars 1–4 (Basic Requirements)	28	5.3
Higher Education and Training	65	4.4
Efficient Goods Market	56	4.4
Labor Market Efficiency	37	4.6
Financial Market Development	54	4.3
Technological Readiness	83	3.5
Market Size	2	6.9
Pillars 5–10 (Efficiency Enhancers)	30	4.7
Business Sophistication	43	4.4
Innovation	32	3.9
Innovation and Sophistication Factors	33	4.1

scandals, has highlighted the relevance of accounting and reporting standards and transparency for preventing fraud and mismanagement, ensuring good governance, and maintaining investor and consumer confidence. Private-sector transparency is indispensable to business; it can be brought about through the use of standards as well as auditing and accounting practices that ensure access to information in a timely manner.

Macroeconomic Environment

China ranks 1st on inflation, 5th in gross national savings, 22nd in government debt, and 25th in credit rating. The stability of the macroeconomic environment is important for business and, therefore, is significant for the overall competitiveness of a country. Although it is certainly true that macroeconomic stability alone cannot increase the productivity of a nation, it is also recognized that macroeconomic disarray harms the economy, as we have seen in recent years, conspicuously in the European context. The government cannot provide services efficiently if it has to make high-interest payments on its debts. Running fiscal deficits limits the government's future ability to react to business cycles. Firms cannot operate efficiently when inflation rates are out of hand. In sum, the economy cannot grow in a sustainable manner unless the macroenvironment is stable. Macroeconomic stability captured the attention of the public most recently when advanced economies, notably the U.S. and some European countries, needed to take urgent action to prevent macroeconomic instability when their public debt reached unsustainable levels in the wake of the 2008 global financial crisis. China's basic macroeconomic environment rates high on stability and has provided a secure environment for transacting business. However, China's macroeconomic stability began to be questioned in 2015 and 2016 as economic growth has slowed and public and private debt has risen at an alarming rate.

Higher Education and Training

Although China ranks 4th in primary school enrollment, it ranks 72nd in secondary education enrollment, 52nd in quality of education system, and 85th in quality of business schools. Quality higher education and training is crucial for economies that want to move up the value chain beyond simple production processes and products. In particular, today's globalizing economy requires countries to nurture pools of well-educated workers who are able to

perform complex tasks and adapt rapidly to changing economic environments and the evolving needs of the production system. The extent of staff training is also taken into consideration because of the importance of vocational and continuous on-the-job training—which is neglected in many economies—for ensuring a constant upgrading of workers’ skills. The Chinese university system needs to be drastically improved if it hopes to grow into an innovation-driven economy.

Technological Readiness

China’s inability to reach a higher level of economic development is demonstrated by the Pillar of technological readiness where it ranks 97th in the availability of latest technologies, 75th in the percentage of individuals using the Internet, and 120th in international Internet bandwidth. In today’s globalized world, technology is increasingly essential for firms to compete and prosper. The technological readiness Pillar measures the agility with which an economy adopts existing technologies to enhance the productivity of its industries, with specific emphasis on its capacity to fully leverage information and communication technologies (ICTs) in daily activities and production processes for increased efficiency and enabling innovation for competitiveness. ICTs have evolved into a general use technology; given ICTs’ critical spillovers to other economic sectors and role as an industry-wide enabling infrastructure, ICT access and usage are key enablers of countries’ overall technological readiness. China needs to invest much more in its ICT structure and open these technologies for public use.

Future Potential for Economic Expansion

The weaknesses in the Chinese economy were illustrated in the previous section. These weaknesses should also been seen as opportunities for foreign companies and investors. However, China has other problem areas that include rising local debt, potential property bubbles, outflows of capital, shadow banking, excess capacity in industry sectors, and endemic corruption across industry sectors. China’s explosive economic growth of the last several decades is beginning to slow. In 2013, real GDP grew 7.7 percent (down from 10.4 percent in 2010). China’s targeted growth rate for 2016 is down to 6.5 percent. U.S. companies doing business in China are concerned about rising labor costs, lax enforcement of intellectual property rights, unfair competition with Chinese state-owned or state-supported companies, lack of transparency, burdensome bureaucracy, and protectionism in the business licensing and approval process. Corruption has also been a longstanding problem evident by government officials becoming wealthy despite having meager salaries. **Transparency International** publishes a **Corruption Perception Index** for countries. In its 2014 Index, China ranked 100 out of 178 countries rated with a score of 33 out of 100 points, with 100 being the least corrupt.

Shadow Banking refers to financial intermediaries involved in facilitating the creation of credit across the global financial system, but whose members are not subject to regulatory oversight. The shadow banking system also refers to unregulated activities by regulated institutions. The shadow banking system has escaped regulation primarily because it does not accept traditional bank deposits. As a result, many of the institutions and instruments are able to undertake higher market, credit, and liquidity risks, and do not have capital requirements commensurate with those risks.

Despite these and other longstanding concerns, China remains an extremely attractive market for foreign companies. Furthermore, many of the economic reforms called for as part of the **Third Plenum** of the Communist Party, particularly those related to foreign investment, are beginning to be implemented.

- revising the three basic laws that govern foreign investment in China
- slashing the number of business or administrative approvals needed while delegating much of the approval responsibility to provincial or local governments

- relaxing “paid in” and minimum registered capital requirements for foreign-invested enterprises, and replacing the annual government inspection procedure with an online filing system
- undertaking efforts to improve the legal and enforcement regime for IPR, and amending the trademark law to provide stronger protection and enforcement tools for trademark owners
- liberalizing financial controls, including the loosening of restrictions on interest rates and on foreign exchange.

For many companies, representation in China by Chinese agents, distributors, or partners is often warranted because they can provide local knowledge and contacts that will be critical for success. IPR holders should understand how to protect their IP under Chinese law before entering the Chinese market, and should conduct thorough due diligence on potential partners or buyers before entering into any transactions. All companies, IPR holders and otherwise, should consult closely with lawyers who have extensive experience with the Chinese market, including lawyers based in the U.S. and China.

Doing Business in Hong Kong, SAR

Hong Kong is a **Special Administrative Region (SAR)** of the People’s Republic of China since its reversion from the United Kingdom in 1997. China has designated some areas of the country as Semi-Autonomous Regions (SAR), such as Hong Kong and Macau. “Semi-autonomous” means they have some degree of independence in regulating their own affairs, taxation, and separate government authorities. But it must always be noted that the ultimate power resides with the national government in Beijing. This section will focus on Hong Kong SAR due to its status as a global financial and trading capital, as well as a strategic departure point for doing business elsewhere in China. Unlike Mainland China, Hong Kong ranks number one in the Asia-Pacific area for economic freedom, while Macau ranks number eight.

Hong Kong had been under the control of the United Kingdom based upon a 99-year lease that expired in 1997. In 1997, Hong Kong reverted back to control of China. The British negotiated certain guarantees and protections for the citizens of Hong Kong (**Joint Sino-British Declaration**), which were partially embedded in the **Basic Law of the Hong Kong Special Administrative Region of the People’s Republic of China** or the **Basic Law**, which acts as Hong Kong’s constitution. This arrangement provides a degree of independence to Hong Kong in managing their own affairs and has become popularly known as “**one country, two systems**.” The agreement with the United Kingdom calls for popular elections of the Mayor and legislature, as well as securing basic personal rights until the year 2047.

However, Mainland China has exerted more and more pressure and control over the Hong Kong government. In 2014, students protested in the streets; these protests became known as the **Occupy Central Movement**. The key issue, among a number of complaints, was the overall tone of a “White Paper” issued by China’s State Council essentially redefining the meaning of “one country, two systems.” The White Paper emphasized by “one country” giving total control over the Hong Kong government to the Mainland government. Specifically, it reneged on a promise to allow open elections for Mayor to all candidates in 2017. Currently, the Mayor of Hong Kong is elected by “Hongkongers,”¹⁵ but only from a slate of candidates approved by Beijing. The Mayor is thus seen as a representative of the Communist Party and not representative of the interests of Hong Kong. The White Paper is part of the new **Greater China Policy** that promotes the idea of China as a fully integrated and homogeneous country, which encompasses Hong Kong and other SARs, as well as the country of Taiwan.

Hong Kong Legal System

The legal tradition in Hong Kong installed during the 99-year occupation by the British is the common law, as opposed to the civil-customary law system of Mainland China. Hong Kong also has its own legal currency (Hong Kong dollar), customs jurisdiction, and does not require a Visa for visits of 90 days or less. Beginning in the 1970s, what is known as the **Golden Years of Colonial Rule**, the British began to educate Hongkongers in the rule of law and the importance of procedural fairness, as well as building civic pride through civil improvements known as the **Rose Garden Strategy** and by building a strong belief that Hong Kong was a “city of law.”

Given its history of treating the rule of law, especially procedural law, as a core principle, administrative litigation is much more robust as compared to the Mainland. Also, due to its common law tradition, administrative litigation comes under the broader common law term of **judicial review**. Prior to its retrocession in 1997, as a British colony, it did not have the authority to make “final” judicial decisions. Hong Kong had its own British-administrated court system with the Court of Appeal being the highest court, but decisions of the Court of Appeal could be further appealed to the **Privy Council** in London.

Privy Council: The Council was formerly a supreme court of appeal for the entire British Empire (other than for the United Kingdom itself), and continues to hear appeals from British Overseas Territories, such as Bermuda and Barbados, and some independent member countries of the Commonwealth. It is known as the Judicial Committee of the Privy Council and is made up of UK Supreme Court justices and high justices from Commonwealth countries. The Commonwealth comprises 53 countries, including Australia, Bangladesh, Canada, India, Nigeria, Pakistan, and South Africa. In 2014–2015, it received numerous appeals from the Supreme Courts of the Bahamas, Jamaica, and Trinidad and Tobago.

After its separation from the United Kingdom, Article 81 of the Basic Law established a new higher court called the **Court of Final Appeal (CFA)**, creating a four-tier court system, with the CFA on top of the hierarchy, followed by the Court of Appeal, Court of First Instance, and the District Court. It is a hybrid system in that the Court of First Instance and the District Court are both trial courts; however, the Court of First Instance can hear appeals from the District Court. Also, depending on the nature of the case, appeals from the District Court can go directly to the Court of Appeal. It is important to note that since Hong Kong has its own Basic Law (Constitution), the People’s Supreme Court in Beijing has no authority to review the decisions of the Hong Kong CFA.

The last Governor under British rule opened up the courts to personal claims of individuals against Hong Kong (British) government agencies. These rights were exercised freely and often. Thus, even though Hongkongers were not given political rights (right to vote), they were given personal rights. The tradition of common law judicial review was recognized in Article 35 of the Basic Law: “Hong Kong residents shall have the right to institute legal proceedings in the courts against the acts of the executive authorities and their personnel.” This is a more meaningful right than is found in Mainland China because of Hong Kong’s tradition of an independent judiciary. Hongkongers have more trust and confidence in the judiciary than they do of the executive and legislative branches of government, and it is the reason that they do not hesitate to bring claims for judicial review of actions taken by the other two branches of government. It is firmly established that the Hong Kong courts have the authority to declare legislative acts or laws as unconstitutional. However, the White Paper discussed above mentioned for the first time that judges needed to be “patriots” as well as administrators, which threatens the core principle of an independent judiciary in Hong Kong.¹⁶

Hong Kong Economy and International Business

Hong Kong’s economy is driven by private consumption (retail sales), logistics and business services, financial services, real estate development, and tourism. Hong Kong has benefited from continued economic integration with Mainland China’s economy. It has a population of about 7.5 million, with 55 million visitors per year, and GDP per capita of \$38,500. Its exports to the United States are about \$43 billion. Its major trading partners include Mainland China, United States, EU, Japan, and Taiwan. Hong Kong has become one of the world’s most important financial centers. This is due to its world-class infrastructure; free flow of information; no restrictions on inward or outward investment; no foreign exchange controls; no nationality restrictions on corporate ownership; and a simple, low-tax regime.

Hong Kong is an ideal platform for doing business in Asia, especially for doing business with Mainland China. Hong Kong is a free port that does not levy any customs tariff and has limited excise duties. Its strong rule of law and respect for property rights make it a strategic location for U.S. companies, especially small- and medium-

sized firms, seeking to do business in Asia. According to Hong Kong Government statistics, there are 1,339 subsidiaries of U.S. parent companies in Hong Kong. Among those U.S. subsidiaries, 822 are regional headquarters or offices.¹⁷

The **Closer Economic Partnership Arrangement (CEPA)** offers Hong Kong's companies' preferential access to the Mainland China's market. Foreign overseas companies can also benefit from the CEPA. For trade in goods, foreign investors can set up production lines in Hong Kong to produce goods that meet the CEPA rules of origin requirements. For trade in services, companies incorporated in Hong Kong by foreign investors can make use of CEPA after conducting business operations in Hong Kong for three to five years or by partnering with or acquiring a CEPA-qualified company.

The trend of foreign firms heading directly to the Mainland was accelerated by China's 2001 admission to the WTO. Companies that go directly to China without sufficient due diligence, however, often face higher costs and longer delays than if they had first engaged a Hong Kong-based intermediary. Hong Kong is home to a large number of *procurement agents* and purchasing offices. Many purchasing decisions for major projects and conglomerates in Macau, Mainland China, or other countries are made in Hong Kong.

The **Pacific Bridge Initiative (PBI)** is a collaboration between the U.S. Commercial Service, the **Hong Kong Trade Development Council**, and U.S. **National Export Initiative (NEI)**, which has the goal of doubling U.S. exports within five years and supporting two million U.S.-based jobs. Hong Kong is also a priority market to attract foreign investment to the U.S. **SelectUSA**, which is a U.S. government-wide initiative to promote FDI in the United States in order to create jobs, spur economic growth, and promote American competitiveness. Over 60 percent of China's overseas investment flows through Hong Kong's financial institutions.

Given Mainland China's size and diversity, it is usually advantageous to work with different agents for different regions of the country. Hong Kong-based agents and distributors are well connected to companies in Macau and Southern China. Serious U.S. exporters should provide Chinese-language materials, respond quickly to inquiries, meet relevant standards, and visit the market for first-hand understanding and relationship building. Unlike traditional Chinese and Japanese methods of relationship or trust building before entering contracts, in Hong Kong, decisions are made more quickly. Firms must respond immediately to inquiries or risk losing opportunities to faster-moving competitors.

Chapter Summary

- 1 In the 1980s, China started its "Open Door Policy" and its transformation from a socialist planned economy to a market (capitalist) economy. In order to accomplish this goal, China passed many Western-style commercial laws including investment, joint venture, property, contract, and intellectual property laws. Most importantly, China recognized private property rights and the freedom to transfer property. It was one of the original signatories, along with the United States, to the United Nations Convention on Contracts for the International Sale of Goods (CISG). China's retooling of its economy and its substantive laws and regulations was rewarded by its entry into the World Trade Organization (WTO) in 2001.
- 2 China has become the world's largest "efficiency-driven" economy. Its major competitive advantages include the world's largest consumer market; willingness to adopt and constantly modernize its business laws and regulations to attract foreign investment; and cultural norms, such as a strong work ethic, the importance of saving, and the importance of community (*Guanxi*) that includes respect for others and the obligation to take care of the elderly.
- 3 China's political-governmental system can be described as parallel systems in which the Communist Party acts as a shadow government and is the true holder of power. The Communist Party structure mimics the government structure and the organization of society. The smallest societal organization or "cell," such as local charities, must include members of the Communist Party.
- 4 Hong Kong demonstrates the diversity of the Chinese legal system with Mainland China's system based on civil and customary law, Hong Kong's system based upon English common law, and Macau's based upon

Portuguese civil law. Hong Kong's principle of judicial independence and rule of law is far superior than its Mainland's counterparts. Hong Kong has a long tradition of viewing the courts as having the power of judicial review over government decisions. The courts may overturn decisions of government agencies if they determine the decisions to be unconstitutional. In comparison, administrative litigation on the Mainland is inefficient as courts are reluctant to overturn administrative (government) decisions, and the independence of the judiciary is questioned.

- 5 A foreign company considering an equity joint venture is restricted by numerous requirements in the Chinese Joint Venture Laws. These requirements include the need to obtain an examination and approval of the joint venture agreement by government agencies, according to the *principle of equality and mutual benefit*; organize the joint venture as a Chinese limited liability company; make a minimum capital investment of 25 percent; the inability to terminate the joint venture unilaterally; the need to provide advanced technology; and the need to maintain a foreign exchange account.
- 6 Chinese contract law is a product of legal transplantation and reception of various foreign legal systems. The basic contract law (Chinese Contract Law) is based upon the Convention on Contracts for the International Sale of Goods (China's international sales law), the UNIDROIT Principles of International Commercial Contracts (model law), with heavy influences from German law, and some influences from the common law and the American Uniform Commercial Code.
- 7 The Chinese administrative law system includes Administrative Reconsideration Law and Administrative Litigation Law. The person or company challenging a decision or failure to act of a government agency has the choice of appealing to a higher level of the government (Reconsideration) or to directly file a claim in the court system (Litigation). Unfortunately, courts are hesitant to overturn a decision of a government agency and often coercively use court-mandated mediation to continually delay the rendering of a decision.

Key Terms

Administrative Litigation Law (ALL)	Chinese Contract Law (CCL)	Great Qing Code
Administrative Reconsideration Law (ARL)	Chinese Corporate Law	<i>Guanxi</i>
Analects of Confucius	Chinese Limited Liability Company	Guiding Cases
Arbitration Law of the People's Republic of China	Closer Economic Partnership Arrangement (CEPA)	Hong Kong Trade Development Council
Basic Law (Constitution)	Communist Party	Hybrid Arbitration Clause
Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China	Company Law of the People's Republic of China	ICSID (Investor-Country Arbitration) Convention
Brand Protection Units	Concrete Administrative Action	Innovation-Driven Economies
BRIC Countries	Confucius; Confucianism	International Centre for Settlement of Investment Disputes (ICSID)
Central Committee	Corruption Perception Index	Interpretative Decisions
Certificate of Approval	Court of Final Appeal (CFA)	Joint Sino-British Declaration
Certificate of the Right to Use	<i>Culpa in Contrahendo</i>	Judicial Review
China Arbitration Association	<i>Danwei</i>	Land Administration Law
China Chain Store Franchise Association	Deng Xiaoping	Law on Franchise Regulations
China International Economic and Trade Arbitration Commission (CIETAC)	Efficiency-Driven Economies	Law on the Organization of People's Courts
	Emergency Arbitrators	Lawyers Law
	Explanations on Several Issues Concerning the Implementation of Administrative Litigation Law	Mao Zedong
	Factor-Driven Economies	Ministry of Foreign Trade and Economic Cooperation (MOFTEC)
	Golden Years of Colonial Rule	
	Greater China Policy	

Multilateral Investment Guarantee Agency Convention (MIGA)	Personality Confusion Politburo Privy Council	Standing Committee State Council
National Export Initiative (NEI)	Real Property Registry	State-Owned Enterprise (SOE)
National People's Congress	Regulations on the Administration of Commercial Franchise	Supreme People's Court
New Company Law	Right to Use	System for Judicial Supervision
New Property Law	Rose Garden Strategy	Tang Code
Nomenklatura System	SelectUSA	Third Plenum
Occupy Central Movement	Shadow Banking	Transparency International
One Country, Two Systems	Sino-Foreign Cooperative Joint Venture Enterprise Law	Transplantation
Open Door Policy	Sino-Foreign Equity Joint Venture Enterprise Law (EJV)	Twelve Pillars of Competitiveness
Opinion on Positive Roles of Litigant Mediation in Constructing Socialist Harmonious Society	Special Administrative Region (SAR)	U.S.–China Joint Commission on Commerce and Trade (JCCT)
Pacific Bridge Initiative (PBI)		World Economic Forum

Chapter Problems

- What is the difference between international business transactions (exporting or importing of goods, services, or intellectual property) and “doing business” in a country? What are the benefits of establishing a business in China? What are the risks of doing business in China? How can a business minimize the risks of doing business in China?
- What is the difference played by the Chinese Constitution as compared to the U.S. Constitution? Which one is easier to amend?
- What are the differences between the legal systems of Mainland China and Hong Kong? How is the role of law in society? What are the differences between the “rule of law” in Hong Kong as compared to Mainland China?
- What are the benefits of establishing a business in Hong Kong and not in Mainland China? What is the strategic value of placing your business in Hong Kong?
- What issues does the size of the population of China and the low per capita income present to a company wanting to establish a presence in China? How does this affect the types of products and the marketing of those products in China?
- Ethics Question: How should a company respond to China's discrimination of certain minority groups and human rights violations? How does your company deal with the prevalence of corruption in government agencies? See Chapter 2.
- Does China have adequate laws for protecting intellectual property rights? Why is the counterfeiting and piracy of goods protected by patent and trademark law so common in China? What can your company do to protect its rights? What provisions should be incorporated into your licensing contracts? See Chapter 19.

Internet Exercises

- Use the web site <http://www.lawinfochina.com> to research one of China's provinces for the purpose of doing business. Select a rural province and compare its environment and laws for doing business as compared to doing business in Beijing or Shanghai.
- Go to the Transparency International web site at www.transparency.org. Research the rates of corruption and the criteria used for the rankings and compare the BRIC countries (Brazil, Russia, India, and China), as well as Japan, Republic of Korea (South Korea), Taiwan, Singapore, and Malaysia.

Other Internet Sources

Go to export.gov/china for current articles on China, along with trade and industry news.

Chinese Government site entitled “Invest in China”: http://www.fdi.gov.cn/pub/FDI_EN/default.htm (click on “English”).

American Chamber of Commerce in China: <http://www.amchamchina.org>.

Exporting to China: <http://www.e-to-china.com>.

Notes

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- 2 See <http://www.heritage.org/index/country/china>.
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- 8 *Ibid.*
- 9 *Ibid.* at 18.
- 10 Yuwen Li and Yun Ma, “The Hurdle is High: The Administrative Litigation System in the People’s Republic of China” in *Administrative Litigation Systems in Greater China and Europe* 15 (ed. Yuwen Li, Ashgate: 2014).
- 11 *Ibid.* at 24–25.
- 12 *Ibid.* at 40.
- 13 Source: Eurostat.
- 14 See <http://reports.weforum.org/global-competitiveness-report-2014-2015/methodology>.
- 15 This term was recognized in the 2014 edition of the *Oxford English Dictionary*.
- 16 Carol Jones, *Lost in China? Law, Culture, and Identity in Post-1997 Hong Kong* 8 (Cambridge 2015).
- 17 Department of Commerce, Export.gov, “Doing Business in China” at http://export.gov/worldwide_us/index.asp.



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Part IV

COMPARATIVE LEGAL SYSTEMS, CONTRACT, AND SALES LAW



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COMPARATIVE LEGAL SYSTEMS

How people view the role of law in society is shaped by the cultural and legal traditions that have evolved within their society. Within a given legal tradition rules of law and their applications by courts are understandable and coherent. However, in the area of international business transactions there is often a “clash of traditions” that may lead to misunderstandings and disputes. Furthermore, even in cases where a foreign party is correct on the issues and this correctness is confirmed by a foreign court, the remedies given (such as specific performance, injunction, and damages) may be far below the level given in the foreign party’s legal system. Thus, an astute businessperson and international transactional lawyer should be aware of the differences in the legal traditions and legal systems that they plan on doing business.

The uncertainty of applicable law in international business transactions is largely due to the unpredictability of what law or laws a court or arbitration panel may select to apply to a given dispute. This area of law is referred to as private international law or **conflict of laws**, the rules courts use to determine the applicable law. Conflict of law rules are complex and can result in unexpected results. As discussed in Chapter 4’s coverage of “International Commercial Dispute Resolution,” the legal risks of the application of foreign law and resolving disputes in foreign courts may be minimized through the use of **choice of law** and **forum selection clauses**. The problem with such clauses is that they are not foolproof since a foreign court may simply disregard their application often on public policy grounds (application by the foreign court of the chosen law’s version of a legal rule would be against the public policy of the court’s national law). Chapter 4 noted that the safest way of avoiding the application of a foreign law is through an **arbitration clause**. But, even in cases of arbitration, foreign legal traditions and influences play a role since the arbitrators are products of one or more legal traditions and foreign legal systems. In addition, arbitrators often do not feel constrained by the need to apply a specific national law. Unlike courts, arbitration tribunals are willing to look at a variety of sources (different national laws, international soft laws, *lex mercatoria*) in rendering fair and equitable awards.¹

In contemplating entering contract negotiations within a foreign party, it is helpful if a businessperson obtains a general knowledge of the legal system of the foreign party. This knowledge will allow for the negotiations of contract terms that will be enforceable in the foreign court system. As will be discussed in Chapter 11 on “Comparative and International Contract Law,” the ways of negotiating a contract vary dramatically among different business and legal cultures. Negotiations between businesspersons from Western countries and Eastern countries can be plagued by clashes of styles. Thus, often the Western businessperson is most anxious to negotiate in earnest (hard bargaining) from the very beginning in the hope of concluding a contract as expeditiously as possible. The Eastern businessperson, especially in Japan and China, will take affront to this “rush to contract” by using a more prolonged “courtship” to first build a relationship and trust between the parties before moving to the negotiation of the contract. The businessperson from a common law (English-speaking) legal system should be aware that the civil law legal system recognizes pre-contractual liability for negotiating in bad faith. There is no such type of liability in the common law.

There can also be differences in style between parties of the same legal tradition. For example, Americans generally prefer long, detailed contracts that painstakingly describe their contractual rights and the duties of the parties. German businesspersons, much like the Japanese, prefer shorter contracts limiting the detailed provisions

to technical aspects of the product or service being sold. A general knowledge of the foreign party's cultural and legal traditions would provide guidance in helping to understand the other party's negotiating posture and lead to successful conclusions of contracts. In the case of the Japanese and German businessperson, the rationale for entering shorter, less detailed contracts come from different aspects of their legal and cultural traditions.

In the Japanese and Chinese cases, the differences in negotiating styles and the characteristics of their contracts are a product of broader cultural traditions that have shaped their view of the role of law in society. The importance of law and contracts is somewhat diminished by customary law, which includes deference to status, relationships, and communal harmony. In the German legal tradition the written law is the primary force behind their preference for short contracts. In addition, the principle of good faith plays a dominant role in German contract law. No matter how detailed a contract, the court views it through the prism of good faith. Through this perspective the strict enforcement of contractual rights may be deemed as an act of bad faith. In comparison, in the common law, contracts are strictly enforced under the principle of freedom of contract.

The first part of this chapter will provide general background on the different terms used in describing legal systems and the comparative approach to understanding law. The second part will briefly review some of the main legal traditions found in the world including common, civil, Asian, and Islamic legal systems, as well as the phenomenon of mixed legal systems or jurisdictions. The two most dominant legal traditions—**civil law tradition** and the **common law tradition**—will be a major focus of the review. In studying the Asian legal tradition, the chapter will focus on the Chinese and Japanese legal traditions. It only briefly discusses the **Hindu legal tradition** found mostly in India. The reason is that India, over the past hundred years or so, has also adopted the common law tradition due to it being colonized by the English and its continued membership in the **British Commonwealth of Nations**. The other tradition not covered is the Jewish or **Talmudic legal tradition**. Again, this is due to the fact that Israeli secular law is primarily of the civil law tradition with influences from the common law. The Hindu and Talmudic traditions remain important because they continue to influence the common and civil law in the countries of those traditions, and they also have influenced the development of other legal traditions. **Mixed jurisdictions** include a handful of countries or entities that combine more than one legal tradition. This group includes Louisiana, Quebec, Scotland, and South Africa, which are blends of the civil and common law traditions. The mixed jurisdictions have been heavily studied because they allow for a unique understanding of comparative law.

The third part examines the problems relating to the **transformation of law** in countries of the former Soviet Union and in China's transition from a socialist planned economy to a market economy. The final part of the chapter will examine the emergence of transnational private law (contract, sales, and property laws) that transcends legal traditions and national laws. At the same time, it will discuss the convergence of legal traditions instigated by the free trade era and globalization.

Legal Traditions and Legal Systems

A **legal system** is the body of rules that regulates a given country. A **legal family**, such as the Franco or Napoleonic and Germanic versions of the civil law, is a group of national legal systems that are part of the same legal tradition. A legal tradition is a product of the historical evolution of ways of looking at law and its role in society. Each legal tradition has distinctive characteristics on how law is formulated, applied, and interpreted.

National legal systems are grouped into or aligned with recognized legal traditions and legal families. However, the fact that a country's legal system is a part of a given legal tradition doesn't mean that countries within a given legal tradition have identical or even similar laws. Much of the differences between legal traditions are related to methods of legal thinking and judicial reasoning. Within the framework of legal traditions, the law as it evolves or develops within individual national legal systems of that tradition may diverge in important ways. See Figure 10.1 for a "Map of the Legal Systems of the World."

Some of the differences between national legal systems are obvious, and others are subtler. For example, the civil law tradition, which evolved out of **Roman law**, is divided into two families of law—the **Franco** and the **Germanic legal families**. Figure 10.2 shows the former Roman Empire as it split between the Western and Eastern halves.

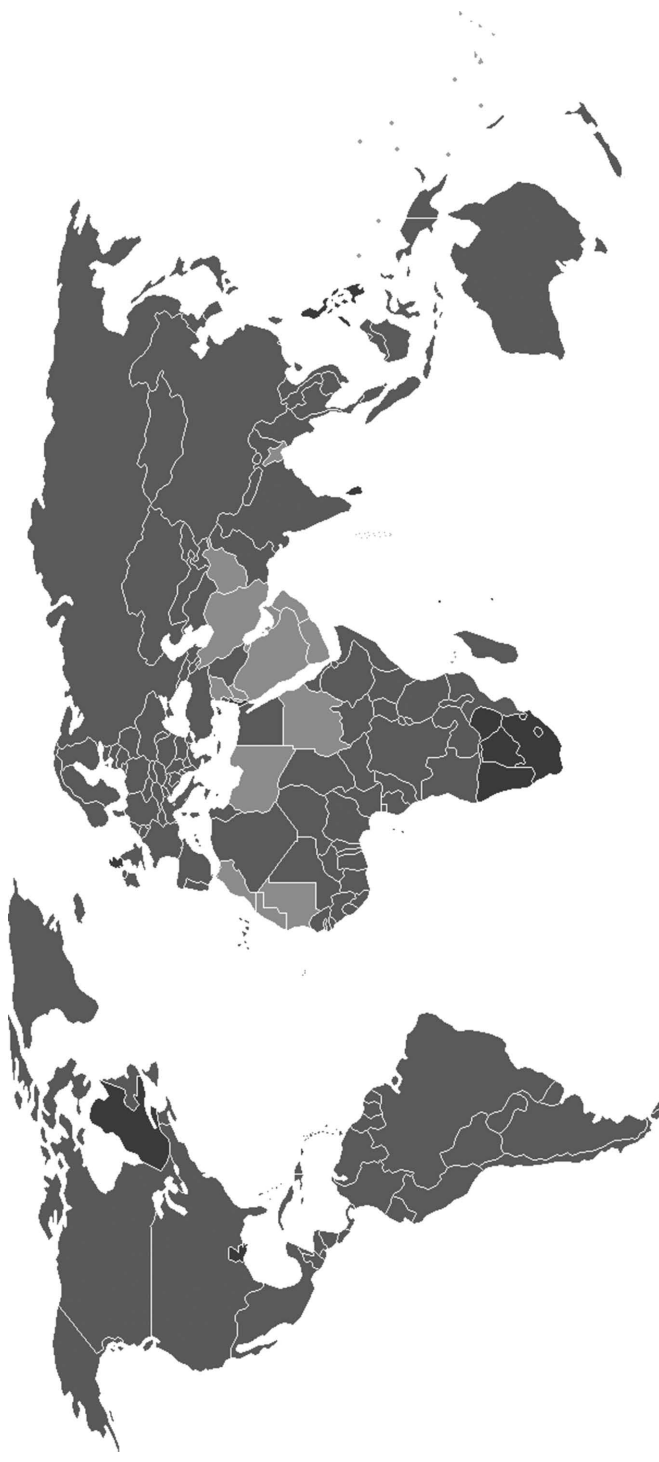


Figure 10.1 Map of the Legal Systems of the World.

Darkest Gray: Mixed Jurisdictions (civil-common law); Dark Gray: Civil Law; Medium Gray: Common Law; Light Gray: Islamic Law.

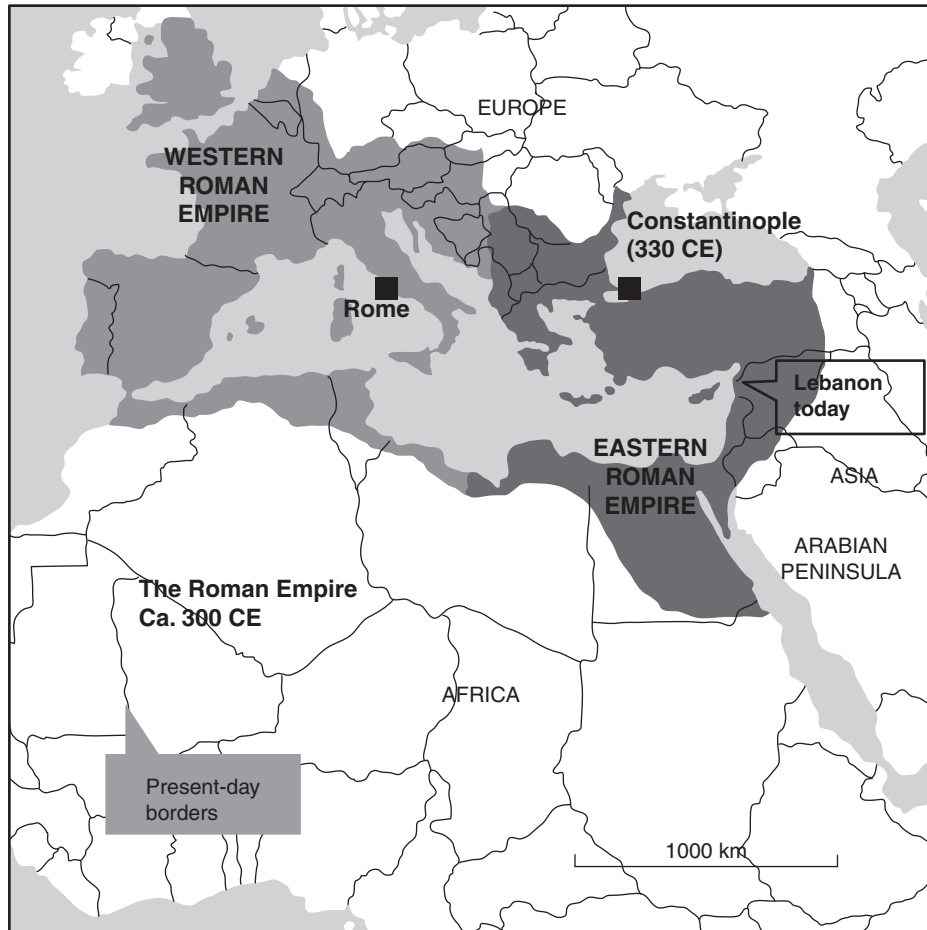


Figure 10.2 Western and Eastern Roman Empire.

(Division Roman after Death of Theodosius I in 395 CE.)

After the barbarian invasions destroyed the Western Empire with the fall of Rome in 476, the Eastern Empire, known as Byzantium, continued to flourish. Its capital city was Constantinople (modern-day Istanbul), and the Empire continued in existence in some form until 1453. Byzantium's importance to law is its production of the **Justinian Code** or **Corpus Juris Civilis** ("Body of Civil Law") in 529–534 CE (see Images 10.1 and 10.2). The *Corpus Juris Civilis* organized Roman law into a coherent document. It was later introduced in Western Europe and became the foundation for modern-day civil law. The common law evolved in England and is the law of the British Commonwealth countries and the United States.² Despite the overwhelming similarity in legal concepts and principles in the common law countries, they have evolved differently in important ways since the various countries gained their independence from England.

Corpus Juris Civilis: It consists of the *Code (Codex)*, which is a compilation, by selection and extraction, of imperial enactments; the *Digest* or *Pandects*, which is an encyclopedia composed of mostly brief extracts from the writings of Roman jurists; and the *Institutes*, which acts as a student textbook.



Image 10.1 Portrait of Justinian I (482–565 CE).

Comparative Contract Law

Comparative contract law research has been undertaken for a number of reasons. First, it has been used as a teaching device to educate students on different legal systems—typically focusing on the differences between the civil and common law systems. A more dense literature can be found in the comparative analysis of different civil law systems, especially between the Germanic and Franco legal traditions.³ Second, comparative contract law has been used as a source in the drafting of international law instruments. The most important example of this is the drafting of the United Nations **Convention on Contracts for the International Sale of Goods (CISG)**. See Chapter 12 on “International Sales Law.” The CISG drew heavily from common and civil law systems. Interestingly, the CISG has not only provided a degree of supranational harmonization, but it has been used as a comparative law instrument in the reformation or modernization of national laws. The CISG has heavily influenced the modernization of contract and sales law in China, Germany, Netherlands, and is likely to have similar influences in the revisions of the French, Japanese, and Spanish Civil Codes.

Third, comparative law can be used to create new laws at the national level. These may include various degrees of influences and **legal transplantations**—the taking of legal rules and codes from one legal system and transplanted to another national legal system.⁴ One interesting example is the country of Vietnam, which has been influenced by a variety of legal systems: The country has absorbed an abundance of imported legal traditions. In successive historical periods—Chinese, French colonial, socialist, and Western commercial—legal ideas have

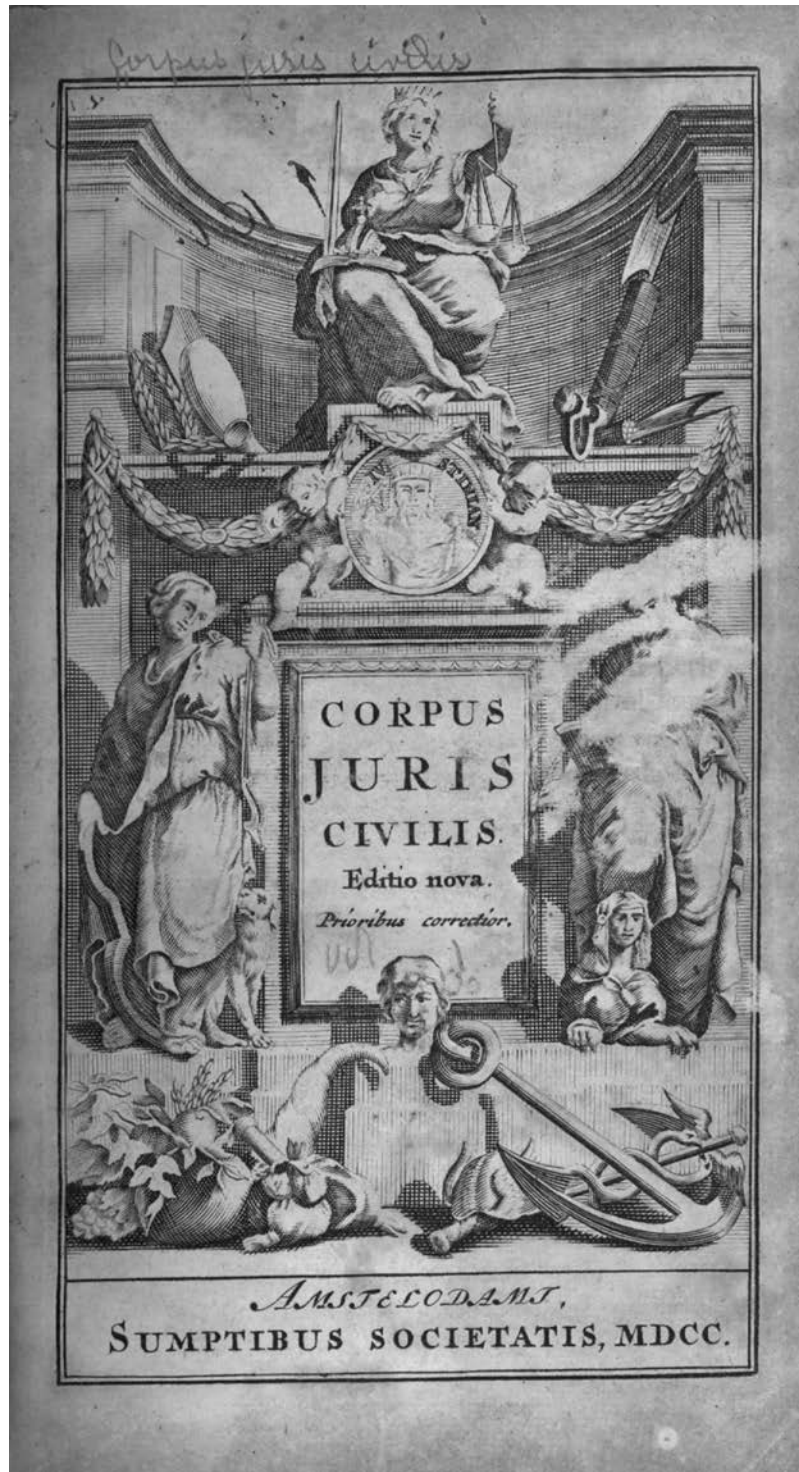


Image 10.2 Corpus Juris Civilis.

created a layered legal architecture, the new overlaying the old.”⁵ The most recent examples can be seen in the transplantation or reception of Western commercial laws by former Soviet-bloc countries and China as it transitioned from a planned socialist to a market economy. See Chapter 9 on “Emerging Economies: China.” Historically, the dominance of the civil and common law systems is due to the transmission of their systems through their former colonial empires throughout the world.

The virtue of comparative law is that it can be used as a method to better understand the evolution of law. Comparative law is also a powerful tool for reforming law as it provides options used in other systems. Alan Watson notes that the formal rules being transplanted are subject to interpretation by the courts of the receiving country. This disconnection between text and context means the rules “may equally operate to different effect in the two societies, even though they are expressed in apparently similar terms.”⁶ This is especially the case when introducing a Western, highly formalized law into a country with non-Western cultural and legal traditions. In China’s case, cultural tradition is heavily based upon the social and status-based influences of **Confucianism**⁷ in which formalized private law has historically played a far lesser role and where cultural norms play a greater role in business relationships, and where resort to the courts as a means of dispute resolution is disfavored. One example of this tradition is the Chinese concept of *guanxi* in which business transactions are regulated by informal social and status-based relational norms. *Guanxi* places a great deal of importance on respect and reputation, and not on the enforcement of formalized contractual rights.

There are two traditional approaches used in comparative law studies—the **common core** and the **better rules** approaches. The first approach, championed by Continental European Scholars, such as Rodolfo Sacco at the University of Turin, as well as Rudolf Schlesinger at Cornell University in the 1950s and 1960s, analyzed the commonalities among different legal systems. The second approach analyzes the differences among legal systems and assesses which of their different rules are the “better” ones. This comparative law methodology seeks through a comparison of the legal rules and techniques of different jurisdictions the best solutions to legal problems. The aim is to identify better solutions in foreign legal systems and then to recommend their incorporation into domestic law.

Major Legal Traditions

This part will focus on the largest or most important legal traditions and legal families—Chinese, Civil, Common, Hindu, and Islamic. It also reviews the mixed jurisdictions of Scotland and South Africa. It finishes with a discussion of the idea of an evolving **transnational law**. It is important to note that the role of law in society and the role of court systems can be heavily influenced by broader historical and societal practices, known as **customary law**. As noted in Chapter 9 and above (discussion of *guanxi*), despite China’s adoption of Western commercial laws, old customary practices of status, respect, relationships, and regard for the community persist in how Chinese view the law and their disdain for litigation (although litigation rates have increased in recent years). Mongolia is one of the few remaining legal systems that rely primarily on customary law.

Customary Law: As the term implies, customary law is based upon the customs of a community. Common attributes of customary legal systems include an oral tradition, an organized set of rules regulating social relations, and that members of the community approve of the rules and customs. Customary law is the basis of or has influenced the present-day laws in approximately 40 countries, mostly in Africa, but some in the Pacific Islands, Europe, and the Near East. Customary law is also referred to as “indigenous law” or “folk law.”

Civil Law Tradition

The civil law tradition emanated out of continental Europe and spread throughout the world during the era of empire and colonialism involving France, Netherlands, Portugal, Spain, and Germany. It is the legal tradition found

throughout Europe (except for the United Kingdom and Ireland), most of Africa, South America, and Asia. See Figure 10.3 on the “Evolution of Civil Law Systems.”

The common law is based upon judge-made or case law, especially in the areas of private law—contracts, property, and torts, while the civil law is a code-based legal system. The civil law traces its origins to Roman law. The modern continental European legal systems are far more advanced and comprehensive than the Roman legal system, but Roman law is still taught in many European law schools. However, Roman law was not directly adopted into the legal systems of Europe. After the collapse of the Roman Empire in the eastern part of Europe, Roman law was no longer used except in a few parts of Italy. Instead law was much more rudimentary based upon local customary, folk, or tribal law. Theses “native” laws, such as the law of Germanic tribes, were mainly unwritten. It also served to support the Feudal system of land ownership, which bound most of the people (serfs) to the land. Roman law was “rediscovered” in the eleventh century.⁸ This rediscovery of Roman law was at least partially a reaction to the expansion of Arabic law as the Arabs gained control of much of the Mediterranean Sea, including Spain. Part of the legal void was filled by the expansion of Catholicism and the use of canon or church law. Canon law did not replace Roman law, but worked together to replace the local, traditional laws.

The creation of the nation-state and the separation of church and state required a grander and more rational system of law. Inspired by nationalism and using Roman law as a guiding force, French law emerged in the sixteenth century, culminating later in the codification of a Civil Code under Napoléon in 1804. It was the “world’s first national, systematic and rational codification of law.”⁹ About a century later a more advanced code developed in Germany with the enactment of the German Civil Code (**Bürgerliches Gesetzbuch**) of 1900. The German Civil Code was seen as a highly rational law that continued in service until its replacement by a revised code in 2002.

The three most important features of the civil law system that distinguishes it from the common law include: (1) the dominant source of law are codes, usually consisting of a grand Civil Code, along with more specific codes, such as commercial law codes; (2) judge-controlled investigative form of procedure; (3) rejection of judicial cases or court decisions as a form of lawmaking; and (4) the importance of legal academics to the lawmaking process in the enactment of new statutes or in the interpretation of statutes. Under the civil law tradition judges are empowered to establish or find the facts. This approach, known as the inquisitorial or investigative style of civil or criminal procedure, places the judge as an active investigator in uncovering the facts of a dispute or prosecution. In contrast, in the common law, the judge is detached from the fact-finding process, leaving to the lawyers for each side of the case to present the facts, often through witness testimony, to the court. This system is referred to as the adversarial system of civil or criminal procedure.

The **Napoleonic Code** or *Code Napoléon*, and officially *Code civil des Français*, was established under Napoleon I (Napoléon Bonaparte) in 1804. The code forbade privileges based on birth, allowed freedom of religion, and specified that government appointments should go to the most qualified. The categories of the Napoleonic Code were not drawn from earlier French laws, but instead from Emperor Justinian’s sixth-century codification of Roman Law, the *Corpus Juris Civilis*, and, within it, the *Institutes*, which divides the law into persons, things, and actions; likewise, the Napoleonic Code is divided into the laws of persons, property, and acquisition of property (contracts).

The French Civil Code has influenced the development of the laws of Argentina, Austria, Belgium, Bolivia, Chile, Colombia, Costa Rica, Croatia, Czech Republic, Democratic Republic of the Congo, Dominican Republic, Ecuador, Haiti, Lithuania, Netherlands, Slovakia, Spain, and Vietnam.

The German Civil Code has influenced the development of the laws of Denmark, Estonia, Finland, Greece, Japan, Mongolia, Norway, Serbia, Slovenia, Sweden, Switzerland, Taiwan, and Turkey. The Scandinavian countries are a unique civil law system with German and purely Scandinavian law influences and are sometimes categorized as the Scandinavian legal system. German law has also had a strong influence on the development of modern Chinese law, as well as traditional customary law and Soviet law. Other mixed but primarily civil law systems include Portuguese Civil Law, which was influenced by the Napoleonic Code and German Civil Code. Macau, a special administrative region of China, is based on Portuguese Civil Code. There are also a number of unusual transplantations of foreign laws. For example, Romanian law is based upon the Civil Code of Quebec.

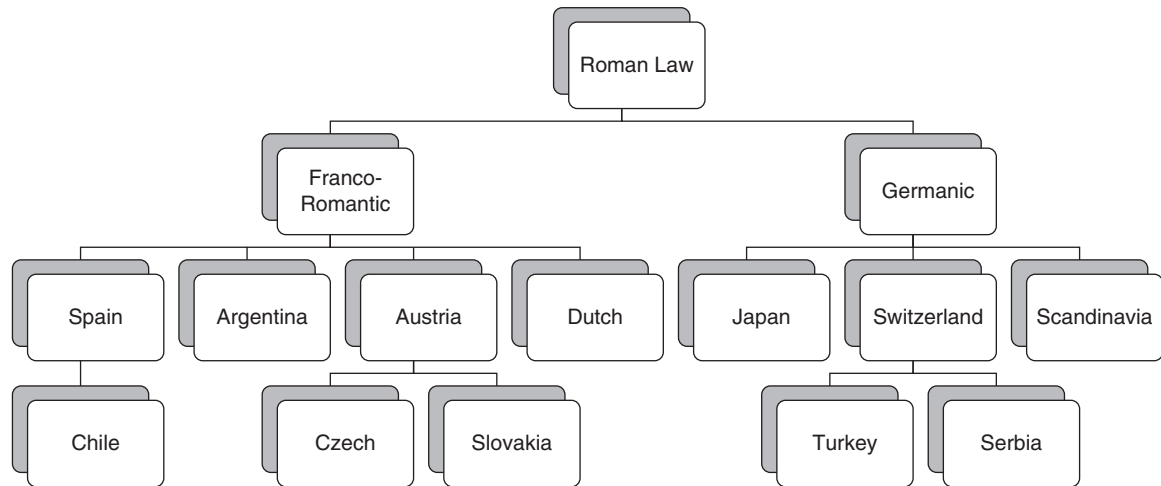


Figure 10.3 Evolution of Civil Law Systems.

Common Law Tradition

The common law countries are the English-speaking countries of the English Empire and subsequently were part of the British Commonwealth of Nations. The United States was an exception, having separated from England by way of a revolution ending with the 1783 Treaty of Paris. Upon its independence, the U.S. adopted the English common law as the law of the new American states. The American Revolution separated the U.S. from England much earlier than the other common law countries, and, therefore, U.S. common law has diverged from English law in important ways. Thus, the two most influential common law systems are the English and American, which are popularly referred to as **Anglo-American law**. The other common law countries include: Australia, Bahamas, Bangladesh, Canada (except for the Province of Quebec), Cyprus, Hong Kong, India, Ireland, Israel (with influences from civil law and Halakha), Jamaica, Malaysia, Myanmar (formerly Burma), New Zealand, Nigeria, Pakistan (with Islamic law influences), Singapore (with Islamic or *Shari'a* law), and Uganda. See Table 10.1 for a “Comparison of Civil and Common Law Systems.”

It is interesting to note that Rome controlled most of England for four centuries ending in 410 CE. However, Roman law had no lasting effect on the development of law directly related to the Roman conquest. After the collapse of the Roman Empire, there was no uniform system of law; instead, law was found in customary law and practices mostly at the local level. The common law tradition evolved in England after the Norman Conquest of 1066. William the Conqueror became king after winning the Battle of Hastings in 1066. See Image 10.3 for a sketch of the “Battle of Hastings.” William the Conqueror centralized the political system, which allowed for the development of a court system and a more “national” law. The Norman Conquest laid the groundwork for the beginning of the common law in the early twelfth century.

Landmark events in the development of English law include: (1) **Doomsday Book** (1086), which catalogued all land ownership in England, allowing the king to more effectively collect taxes; (2) **Magna Carta** (1215), signed by King John, that recognized limitations of the king’s power; (3) **Statute of Westminster** (1285), which recognized the writ system and the ability to appeal from the local courts to the royal courts. A writ is an order from a court to proceed with an action. It is the predecessor to what we know as causes of action (breach of contract, negligence, trespass, and so forth). However, the writs were narrow, and a party could not pursue a legal action in many cases since there was no applicable writ. For example, there was no writ for a breach of contract until the writ of *assumpsit*, which was an action in tort (harm to person or property), was extended to breach of contract in

Table 10.1 Comparison of Civil and Common Law Systems

Characteristics	Civil Law	Common Law
Other Names	Continental, Romano-Germanic	English, Anglo-American, judge-made
Legal System	Originated in Europe; its core principles are found in statutory code, which is the main source of law	Originated in England; its core principles are found in case law or judge-made law
Sources of Law	Codes and statutes	Judge-made; legislation (statutes)
Role of Judges	Acts as an investigator whose decisions only affect the parties to the case	Makes ruling; decisions set precedents that must be followed by lower courts in future cases (<i>stare decisis</i>)
Qualifications of Judges	Career Judges (trained in law school to be judges)	Lawyers (appointed or elected)
Countries	Continental European countries, most African and South American countries, as well as Russia, China, and Japan	Former members of the British Commonwealth (English-speaking countries), such as Canada, India, and Australia, and the United States
Role of Legal Scholarship	Secondary Source of Law	Major Source of Law in some countries, such as Germany
Legal Reasoning	Inductive (from facts)	Deductive (from principles of law)
Role of Juries	Only in criminal cases	Only in criminal cases; except for United States (Constitution provides right to civil jury)
Role of Lawyers	Inquisitional System (judge asks questions)	Adversarial (lawyers ask questions)
Judicial Review of Statutes	No	Yes



Image 10.3 Battle of Hastings.

Slade's Case in 1602. (4) Rise of equity courts (fifteenth century) created dual court systems—the royal or law courts, which applied the common law and the courts of equity, which initially applied canon law, before developing general principles of justice and equity to guide their decisions. This proved to be an inefficient system since the two courts could only provide certain remedies. The law courts primarily awarded money damages

(legal remedy), and the equity courts issued equitable remedies, such as injunctions (order to stop doing something) and specific performance (order to do something). So if someone were infringing on your copyright, that party would first go to an equity court to obtain an injunction to stop the infringement. The party would then have to start a second action in a law court to collect damages for the harm inflicted by the infringement. This system was adopted in the American colonies and surprisingly persisted into the late nineteenth century, when a single set of civil procedure rules was adopted establishing a single court system.

Remnants of the old equity system remain to the present. For example, Delaware maintains a dual court system. It still has a Court of Chancery that continues to exist since the American Revolution. The jurisdiction of the Court is simply to hear and determine all matters and causes in equity. Its primary power is its ability to issue injunctions. It has played an important role in the development of American corporation law. More importantly, many of the equitable principles developed in the equity courts are now found in the “law” (principles of good faith, unconscionability or unfairness, promissory estoppel, and so forth).

Writ: The word “writ” is still in use in the U.S. legal system and means to petition a court for an order, such as *writ of mandamus* (court order to force the government to do something they are required to do, such as issue a permit), *writ of habeas corpus* (ordering the government to bring a prisoner or detainee to court and to explain the reasons for his or her detention), and the *writ of certiorari* (petition to the Supreme Court to hear a case on appeal).

The core characteristic of the common law system, implicit in the idea of judge-made law, is the **law of precedent** or **stare decisis** (“let the decision stand”), which requires lower courts to follow the rulings (of law) handed down by higher courts. See Figure 10.4, case study on “Legal Reasoning in the Common Law.” Thus, when an issue comes before a lower court and the issue was previously decided by a superior court in the same court system, the lower court must apply the decision of the upper court. Interestingly, the common law is found at the state level in the United States due to the U.S. Supreme Court’s decision in the 1938 case of *Erie Railroad Company v. Tompkins*. In that decision, popularly known as the **Erie doctrine**, the Court held that a Federal court could not create Federal common law in cases involving parties from two different states (diversity jurisdiction). Therefore, in the private law areas (contract, tort, real property) there are 53 American common laws (50 states, Puerto Rico, U.S. Virgin Islands, and Washington, D.C.).

Canadian Legal System

The entity now known as the country of Canada came into existence through the British North American Act of 1867, which created a confederation of states governed by the constitution (Magna Carta) of the United Kingdom. Despite subsequently passing a “new” constitution, the Constitution of 1867 remains in effect. The 1867 Constitution divides lawmaking power between the federal and provincial governments and makes the law passed by the Canadian Parliament the supreme law of the country.¹²

Canada has 13 provinces and territories: Alberta, British Columbia, Manitoba, New Brunswick, Nunavut, Newfoundland, Northwest Territories, Nova Scotia, Ontario, Prince Edward Island, Quebec, Saskatchewan, and Yukon. Early in its development it was established that each province has the right to determine its own law subject to limitations provided in the *Constitution* (1982) and the *Charter of Rights and Freedoms*. As a result, the English-speaking areas adopted English common law and Quebec adopted the French Civil Code. The provinces and territories, except for Quebec, follow the doctrine of precedent or *stare decisis*; the lower Provincial courts must follow the decisions of the higher level courts (Court of Appeal). Interestingly, the different provinces adopted the English common law at different times, meaning the case law developed differently, creating unique bodies of case law in the different provinces. Just like the United States, the common law provinces adopted the English dual court system involving the Royal or common law courts and the **Courts of Chancery** or equity courts, and just like the U.S., the two court systems were merged in the late nineteenth century.

Legal reasoning is the process by which a court makes a decision. In that decision the courts enunciate in great detail the reasons for their decision.

Justification by Authority (law of precedent): In the common law, the law of precedent or *stare decisis* (“let the decision stand”) often leads a court to a finding based on prior authority (case law). In such cases, the legal mandate is to follow the rulings of higher courts. Hence, the justification is from authority and not one of substance. Justifications of substance (reasons of justice, fairness, and logic) would have already been espoused in the prior decision of the upper court. The common law system, whether in England, the British Commonwealth, or the United States, has stayed true to the role of judges as the institution entrusted in the interpretation, application, and, at times, the creation of the law.

Judge-Made Law and the Appellate Process: The idea of judge-made private law remains the bedrock of all common law systems. Coherency in such a system is ensured through the appellate court process. The appellate courts are entrusted to “unify” the law if there are conflicting rulings, decisions, or interpretations in lower courts (within the scope of their appellate jurisdictions).

Distinguishing Cases: Change is also part of the system, which means higher courts may overturn their own precedents. This process is generally done gradually, often by a process of distinguishing the previous precedent from the facts of current cases. Overtime, this distinguishing or creating exceptions reduces the original precedent or rule to insignificance at which point the court will formerly overturn the precedent. So, for example, the U.S. Supreme Court in a 7 to 1 vote in *Plessy v. Ferguson*¹⁰ held that the principle of “separate but equal” was constitutional, leading the way to black- and white-only public schools (segregation). It overturned that decision in a 9 to 0 vote in *Brown v. Topeka Board of Education*¹¹ by holding that separate but equal was unconstitutional (leading to the integration of American schools and universities).

Ratio Decidendi and Dicta: A lower court only has to follow the reasons and findings of the superior court that were necessary in rendering its decision. The *stare decisis* part of a decision is called the *ratio decidendi* or the reason for the decision. At times judges provide additional support or justification for their decisions or speculate on issues not necessary to decide the particular case being heard. This portion of the decision is referred to as *obiter dictum* or *dicta* and has no precedential value.

Well-Reasoned Decisions and “Avoiding” Precedent: This idea of the force of a precedent refers back to the idea that no two cases are ever identical. If confronted with a poorly justified precedent, a court may seek to distinguish the precedent from the case before the court, resulting in the narrowing of the scope of the precedent. Alternatively stated, a court may elect not to extend the precedent to similar, but not identical fact situations. This is one reason why courts in the common law system expend so much time in providing well-reasoned decisions so that future courts will have the justifications of the precedent readily available for future use. This also explains the evolution of nonbinding *dicta* as a way of a court supporting its recognition and application of a legal

rule, as well as providing guidance for extensions of the rule (precedent) by future courts.

Statutes and the Common Law: Statutes preempt or supplement the common law. But it must be realized that legislative law and codes, after being enacted, become embedded into the common law system. In the end, it is what judges say a statute means that matters and not what the legislature intended. The courts do look at legislative history to determine legislative intent, but the fact is that most statutes are vague and do not provide necessary definitions of phrases used in the statute, so legislative intent is not available or is ambiguous at best. It is for the court to determine the meaning of the words of the statute.

53 Common Laws: A good example of the role of judges in interpreting statutes is the American Uniform Commercial Code (UCC), which has been adopted in all 50 states. However, each state has independent court systems, so the meaning attached to some provisions of the UCC may differ across the states. Put simply as to matters of private law (contracts, torts, real property), there are not one but 53 common laws in the United States (50 states, Puerto Rico, U.S. Virgin Islands, and Washington, D.C.).

Key Points

- In the common law, there are two types of justifications used by judges in rendering decisions—reasons of authority and reasons of substance.
- The common law is based upon judge-made law that requires lower courts to follow the decisions of higher courts. The requirement is known as the law of precedent or *stare decisis*. It is through the appellate court process that higher courts resolve conflicting decisions of lower courts and unify the law.
- Legal precedents that work injustices in particular groups of cases are often distinguished to avoid such results. Over time this distinguishing process leads to an elimination of the obsolete precedent and its formal overturning.
- Judges give detailed reasons for their decisions (*ratio decidendi*), but also give indications of how future (hypothetical) cases relating to related issues should be decided (*dicta*).
- Legislative law or the law of statutes is considered superior to existing case law. However, statutes are embedded in a common law system. Therefore, the ultimate meaning of what a state means is found in the case law interpreting the statute.
- Common law is found at the state level in the United States, which has self-contained legal systems. Therefore, there are 53 common laws in the U.S. and its territories.

Figure 10.4 Case Study: Legal Reasoning in the Common Law.

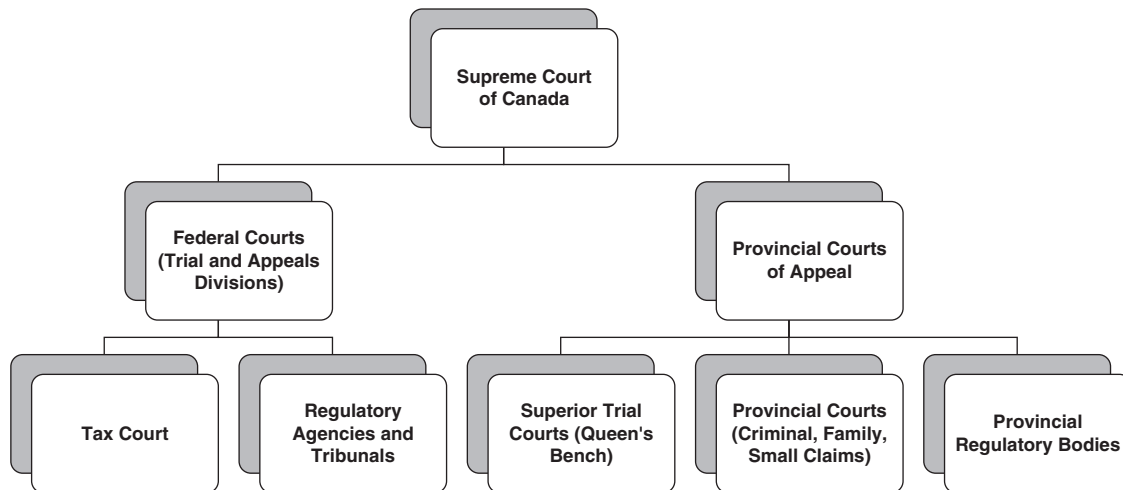


Figure 10.5 Canadian Court System.

The 1867 Constitution allows the provinces to establish their own court systems; therefore, there are some variations across the court system. The Canadian Court system is illustrated in Figure 10.5.

A few distinguishing characteristics of the Canadian court system will be mentioned here. First, the Provincial Courts hear both civil and criminal matters. Second, depending on the Province, some small claims courts have jurisdiction over disputes involving up to \$50,000. Third, not shown in Figure 10.5 is that some provinces have created their own specialized courts. For example, Ontario has established specialized courts for drug-related matters, domestic violence, and mental health cases. Fourth, the superior trial courts are called by various names, such as Queen's Bench, Supreme Court, and Superior Court of Justice (Ontario). The Canadian Supreme Court is located in the national capital of Ottawa. It hears appeals from Provincial Courts of Appeal including those from Quebec. There are nine judges, but only seven have to sit in a case. Finally, the Supreme Court may take "references" submitted by the Prime Minister. For example, in 2004, the court was referred the issue of the legality of same-sex marriage, which eventually led to its legalization in all the provinces.

Civil Law versus Common Law

Civil law is primarily contrasted against common law, which is the legal system developed among Anglo-Saxons in England. The original difference is that, historically, common law was developed by custom, beginning before there were any written laws and continuing to be applied by courts after there were written laws. Civil law developed out of the Roman law of Justinian's *Corpus Juris Civilis* that uses general legal principles. In later times, civil law became codified beginning in the second half of the eighteenth century, but the long-lasting civil codes came after the French Revolution, with the French Civil Code (*Napoleonic Code*) in 1804, Austrian Civil Code (*Allgemeines bürgerliches Gesetzbuch* or ABGB) in 1811, Dutch Civil Code (*Burgerlijk Wetboek* or BW) in 1838, 1889 Civil Code of Quebec in 1866, Spain (*Código Civil*) in 1889, and the German Civil Code (*Bürgerliches Gesetzbuch* or BGB) in 1900. The two most influential civil codes have been the French and German civil codes, which have influenced the drafting of civil codes in other countries. Codification is also found in common law jurisdictions in which parts of the law have been codified, such as in the case of the U.S. Uniform Commercial Code (UCC).

The difference between civil law and common law is not so much that civil law is primarily based on statutory law, but in the legal reasoning and methodological approaches to the application of codes and statutes. In civil law countries, legislation is seen as the primary source of law. Courts base their decisions by directly referring to the

codes and statutes. Courts thus have to reason extensively on the basis of general principles of the code, or by drawing analogies from statutory provisions. By contrast, in the common law system, cases are the primary source of law, while statutes are intrusions into the common law and are interpreted narrowly. It should be noted that even though statutes in the common law are seen as preempting the common law, the statutes are embedded in a common law system. The importance of this fact is that courts rely heavily on other court decisions interpreting the relevant statute rather than relying directly on the statute itself. In the civil law, each court directly interprets the code or statute without citing other court decisions.

There are considerable differences between the legal methodologies of various civil law countries and the common law countries. For example, common law judicial opinions are much longer and contain elaborate reasoning, whereas legal opinions in civil law countries are usually short and formal in nature. This is in principle true in France, where judges cite only legislation, but not prior case law. By contrast, court opinions in German-speaking countries can be long and normally discuss academic writing extensively, along with referring to other case decisions. Civil law judges are usually trained and promoted separately from lawyers, whereas common law judges are usually selected from accomplished and respected lawyers. Also, as seen in the German system, the influence of academic writing by law professors tends to be much greater in civil law countries.

Chinese Legal Tradition

The Chinese legal system and the role of the Chinese Communist Party are also discussed in Chapter 9. The coverage here is a bit more historical and broader in scope. Before discussing the Chinese legal tradition, a brief review of the modern history of China will provide some context. The history of China is primarily a history of imperial dynasties. The Qing dynasty was the last, ending in 1912, followed by the Nationalist government (*guomingdang* or *Kuomintang*) led by Sun Yat-sen and later by Chiang Kai-Shek, before the Communist Revolution (period of “no law”), led by Mao Zedong, in 1949. The current legal system and laws of China have evolved in only recent times after the Cultural Revolution (1966–1976) and the death of Mao in 1976. It was not until the move to a market economy in the 1980s that we began to see a modern legal system. Watershed events in China’s evolution as a world economic power include the rise to power of **Deng Xiaoping** in 1978, China’s reunification with Hong Kong in 1997, and its accession to membership in the World Trade Organization in 2001.

President Deng Xiaoping instituted an ambitious program of economic and legal reforms to transition China from a planned Communist economy to a market economy. Despite the success of these reforms and the resulting explosion of the Chinese economy based upon the exportation of goods, a number of legal orders remain from the prior system—agricultural collectives and **stated-owned enterprises (SOEs)**. Today, real property law remains underdeveloped, as village collectives who contract the land to individual farmers own most rural areas, and individual home ownership is restricted to a 70-year lease. SOEs continue to dominate major parts of the economy.

The first legal and economic reforms were instituted in 1978. First, agricultural reform included the dismantling of the gigantic agricultural communes, which were highly inefficient, and to bringing responsibility for agricultural output to the village and individual levels. Second, SOEs were established and given independent legal status with decision-making powers, thus loosening state control of all enterprises. The SOEs were also weaned off government subsidiaries that dulled their competitiveness. However, inefficiencies continue that only privatization would likely fix—a decision the Chinese government has avoided.

The Chinese legal tradition traces its origins to about the sixth century BC. The tradition centers on the key issue of what is the role of law in society. To answer this question requires a review of the social and political policies dating back to the Qin (221–206 BC or BCE) and Han dynasties (206 BCE and 220 AD or CE). The two major schools of thought that make up the Chinese legal tradition are Confucianism and legalism.¹³ Confucianism stressed the roles of education, cooperation, and living by moral examples in society. Law and the legal system were only, at best, a method of last resort. Instead of acting based upon legal obligations, legal obligations were to be subservient to moral obligations and maintaining the harmony of relationships within the community.

Society was to be regulated by moral and societal values (*li*). The major sanction in such a view of society is shame or a loss of reputation. Confucianism also stressed respect for a person's position or role in society.

In contrast, legalism, which coexisted with Confucianism, stressed the use of law and a strong government as needed to properly regulate society. Legalism was more egalitarian in nature in that it believed in the creation of detailed legal rules (*fa*) to be applied to everyone regardless of their position in the social order. As a philosophy, Confucianism remained the dominant state ideology until the fall of the Qing dynasty in 1912, and continues to play an important role in modern China, shaping the importance of relationships over contracts, respect for others, and the role of law in society. The influence of Confucianism did not deter the development of formal law. As early as the Qin dynasty, criminal law codes were enacted and developed. However, the most influential code was the **Tang Code** developed in the eighth and ninth centuries. The most comprehensive code was the **Qing Code** of 1740, which created a comprehensive legal system, but, again, one primarily focused on criminal law. In the area of private relations and private transactions, Confucianism remained the dominant force. Thus, commercial and civil law remained largely underdeveloped. This was due to numerous factors, such as the lack of commercial codes, the agrarian focus of the economy, and the lack of a strong, independent merchant class able to develop informal merchant law, unlike the development of the law merchant (customary business law) in medieval Europe. As a result, the development of a robust law profession and the establishment of law schools were considered unnecessary.

It was not until the modern era, beginning in 1978, that China enacted Western-style civil and commercial laws. The business and noncriminal laws (civil, contract, commercial) enacted are most closely related to those found in the civil law systems of Europe. This is understandable given the 2,000 years of experience in the development of criminal law codes. In contract law, the two major events were China's adoption of the United Nations Convention on Contracts for the International Sale of Goods (CISG) in 1988 and the enactment of the uniform **Chinese Contract Law (CCL)** in 1999. China was an original signatory to the CISG, when in a coordinated and symbolic effort with the United States it announced the adoption of the CISG on the same day. The CISG is a Western-style law primarily negotiated between civil and common law representatives. The CCL is based upon the CISG, UNIDROIT Principles of International Commercial Contracts, as well as German law influences, and to a lesser extent by English common law. Thus, CCL is understandable to any lawyer of the Western legal tradition. New laws have also been enacted in the area of property and tort law. Finally, the Chinese government announced that work would proceed with a general Civil Code along the lines of the civil law tradition. The **Draft Chinese Civil Code** states its objectives as creating a "supreme document" codifying all private laws; the grounds of all civil responsibility; establishing a clear set of civil judicial standards; and to protect the rights of citizens by ensuring the fair operation of the civil justice system.

Islamic Legal Tradition

Many Muslim countries have adopted *Shari'a* Law. Examples include Saudi Arabia, Afghanistan, Iran, United Arab Emirates (UAE), Oman, Sudan, Malaysia, Pakistan, and Yemen. These countries have Western-style commercial laws, but *Shari'a* (religious) law is considered to be the foundational and superior law. There are four sources of Islamic law including: (1) **Quran** (holy book) and Hadith (sayings of the Prophet), (2) **Sunna** (social and legal customs and practices), (3) **Ijma** (consensus of Islamic scholars), and (4) analogical reasoning. The *Quran* is mostly a guide for personal conduct—norms and guidelines that Muslims are to live by and the proper worship of Allah. The *Sunna* helps fill in the gaps in the *Quran*, but like the *Quran*, is mostly personal in nature. Both the *Quran* and *Sunna* are recordings of the words of the Prophet Muhammad. The interpretations of the *Quran* and *Sunna* by a consensus of scholars often leads to confusion since there is no uniform system of how scholars come together and issue interpretations; so, different groups of scholars may issue different interpretations. The use of analogical reasoning is most like the Western legal systems. For example, analogical reasoning is a common form of legal reasoning in the civil and common laws.

Religious Legal Systems stem from the sacred texts of religious traditions. The main types of religious law are *Shari'a* in Islam, Halakha in Judaism, and canon law in Christianity.

The **Islamic legal tradition** traces its origins to the era of the Prophet Muhammad in the early seventh century CE. The ***Shari'a* law** (“the path”) is the basis of the Islamic legal system, derived from the *Quran* and *Hadith*. The *Quran* means “the recitation” and is the central religious text of Islam. Muslims believe that God verbally revealed the *Quran* to Muhammad through the angel Gabriel from 609 to 632 CE. The *Hadith* means “account” or “report.” The *Hadith* literature is based on spoken reports that were in circulation in society after the death of Muhammad. Islamic scholars then compiled these *Hadiths* together in collections. The *Hadith* collections are different for the Sunni and Shi ‘a branches of Islam. The secondary sources of Islamic law are principles established by Islamic scholars based upon their interpretations of the *Quran* and *Hadith*. These legal rules are called *Ijma* (consensus). Last in importance is the *Qiyas*: when an issue is novel in that a rule cannot be found in the *Quran*, *Hadith*, or *Ijma*, the judge uses “analogical reasoning” to apply an accepted legal principle to the dispute. Judicial decisions are held in high regard but need not be followed in the way of *stare decisis* in the common law system.

Sunni Islam is the largest branch of Islam, accounting for about 88 percent of all Muslims. Sunni Muslims make up a majority of the populations of the countries of Albania, Bangladesh, Indonesia, Malaysia, North Africa, including Egypt, Pakistan, Saudi Arabia, and Turkey, among others. The majority of Shi ‘a countries include Iran and Iraq (also has large minorities of Sunni and Kurds). A third branch, the *Ibadi*, is the majority religion in Oman. Despite the importance of the canonical texts noted above, Islamic law is not a religious law in the generally accepted sense. The confusion lies in the fact that most of the sacred law, such as the *Quran*, stems from the fact that very little of it deals with the subjects covered by most other legal systems. Therefore, most of the law in the areas of commerce and business come from man-made law and not religious law: “The first, *Ibadiit* (ritual), deals with purely religious matters. The second *Muamalat* (transactions) deals with the subjects, which comprise the content of other legal systems.”¹⁴ The *Quran* contains very few legal provisions (only 190 of the 6,237 verses contain legal provisions), and those provisions deal with family and inheritance law. Thus, the legal rules (*fiqh*) found in the *Muamalat* are man-made and are not part of religious law. *Muamalat* is a set of rules related to worldly matters such as business and commerce transactions, finances, and lending matters. Since the charging of interest on a loan and payment of interest on money deposits are illegal under the Islamic legal system, Islam financial rules have been widely studied and used.

Analogical Reasoning: This method of reasoning is used when there is no authority, principle, or rule that directly addresses an issue. In the common law system, the judge would look to prior cases (precedent) with similar fact patterns to extend, adjust, or create a rule to fix the gap in the law. In the civil law system, if there is a gap (*lacunae*) in a code or statute, the judge looks to other code provisions to derive a rule by analogy to fill in the gap.

Most Muslim countries have adopted modern commercial codes and laws. France colonized much of North Africa and the Middle East in the early nineteenth century. Thus, those areas were introduced to the **French Civil Code (Code Napoléon)** of 1804. A majority of Muslim countries in those areas have modern commercial codes based upon the civil law tradition. For example, Egypt adopted a civil and commercial code based upon the French Civil Code. It was updated in 1948 to include Islamic principles and decisions of the Egyptian courts. Again, a new Egyptian commercial code, based heavily on the CISG, was adopted in 1999.

Shari'a law provides fundamental principles, which apply if there is no specific legislation on a topic or issue. It is also used or cited in the interpretation of statutes. Alongside *Shari'a* law are modern statutes, which are applied and interpreted in ways similar to other modern legal systems; however, the courts may still cite *Shari'a* law in supporting a

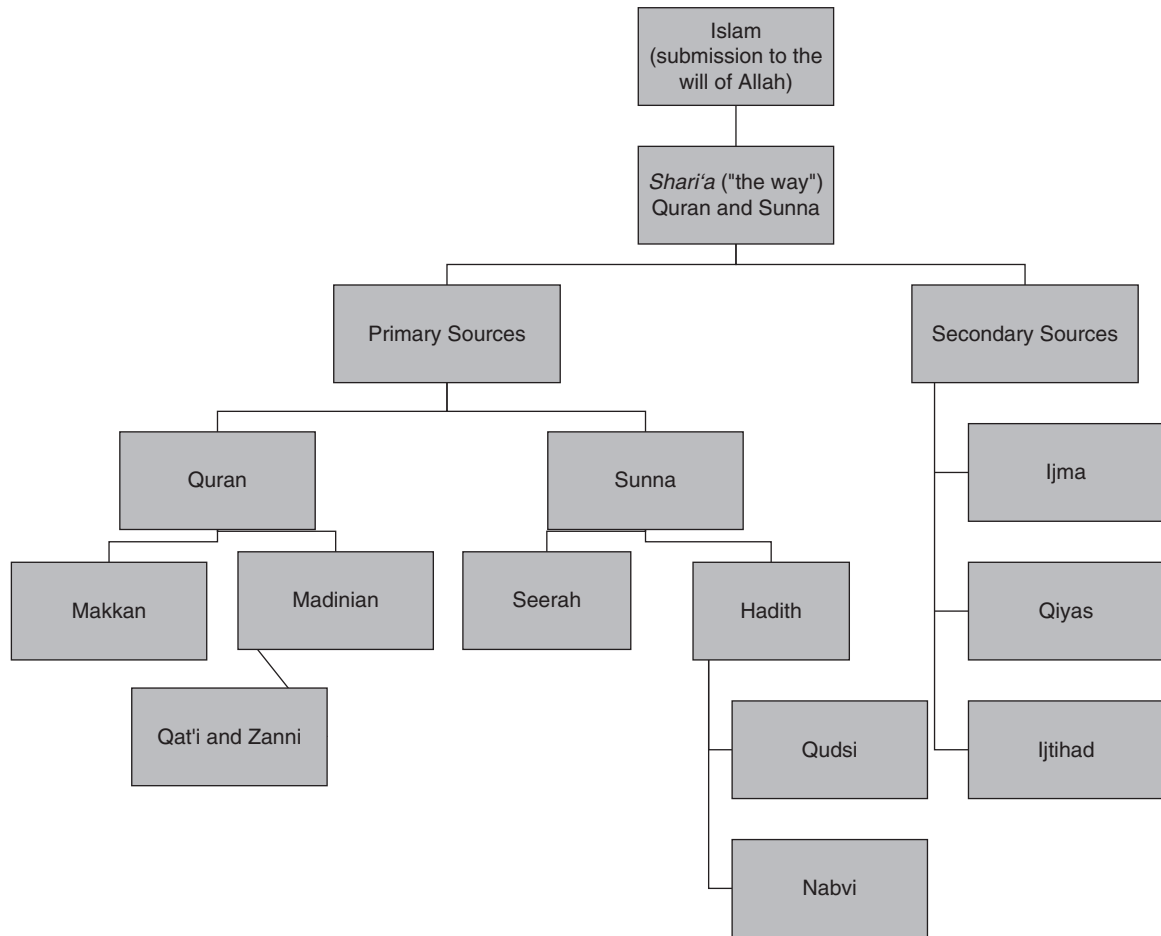


Figure 10.6 Summary of Islamic Law.

particular interpretation of a statute. There is also a great amount of variation in the influence or role *Shari'a* law plays in a given national legal system. In Saudi Arabia, *Shari'a* law touches all aspects of society including the business realm, while Turkey has officially purged Islamic law from its legal system. Before leaving the subject of Islamic law, it is important to point out that this review is simplistic in every way given the complexity and numerous sources of Islamic law. More detail of the sources of Islamic law is provided in Figure 10.6.

The summation of all the interpretations taken from the sources listed in Figure 10.6 makes up the body of *Fiqh*, *Furu*, and *Fatwa* (laws and rules).

Islamic Contract Law

The *Quran* refers to commercial transaction in only a few instances. Islamic scholars have not fashioned a general theory of contracts. Instead, they created rules for particular types of contracts; the most important set of rules is for sales contracts (*bay*), which served as a model for gift (*hiba*), hire (*ija'ra*) (employment or services contracts), and the loan (*a'riya*). Even though *Shari'a* principles may be used to interpret the code or the contract, most issues in contract law are answered by the modern commercial codes.

Islamic Banking and Financial Law

Islamic banking is consistent with the principles of *Shari'a* law. *Al Wadi'ah* means lodge, leave, or deposit. In Islamic banking, *wadi'ah* refers to a safekeeping instrument that allows a person to keep the wealth or assets belonging to oneself with another person. In fact, it was practiced before Islam came into existence. Under an Islamic scheme of savings, customers are assured of interest-free safekeeping services. If the bank cannot charge interest and the depositor cannot receive interest, does that mean the bank gets free use of the depositor's money? The banks may offer their customers a *hiba* or gift based on the earnings of the bank through the investments using their customers' money.

The *Quran* prohibits the charging of *riba* or interest on the lending of money. The prohibition of *riba* (usury) is based on a broader prohibition against making unearned profits. Thus, charging an above-market price in the sale of goods would violate the prohibition of *riba*. However, if the above-market price is shown not to be a product of fraud or monopolistic practices, then the premium price could be considered a gift from the buyer to the seller. Unlike the common law, gift promises are binding contracts.

Ways have been developed in lending and financial transactions to avoid violating the prohibition of *riba*. First, the bank can take an ownership stake in the project that it is lending money to support and hope to earn profits if the venture proves successful. Second, some Muslim countries allow for the payment of interest on delayed payments. Eventually, Islamic rules (*Fiqh al-Muamalat*) have been developed to allow financial transactions that would not violate the *riba* prohibition. For example, instead of lending money for a person or company to buy property, the bank would buy the property directly and then resell the property at a profit to the other party and allow the other party to pay through installments. For a brief summary of the characteristics of the civil, common, Islamic, and socialist legal systems, see Table 10.2 on "Comparison of Four Legal Systems."

Hindu Legal System

Hindu law is one of the world's oldest legal traditions. But Hinduism is more than the formal written law of the Western legal tradition; it is captured by the more elusive term of *dharma*, which describes things like what is considered appropriate behavior, duties, rights, laws, conduct, virtues, and the right way of living. *Dharma* has multiple meanings and is used in Hindu law, philosophy, religion, and Buddhism. The notion of *Dharma* (duty or propriety) is found in India's ancient legal texts. In Hindu philosophy, justice, social harmony, and happiness requires that people live per dharma. The *Dharmaśāstra* is a compilation of a large volume of Hindu treatises called *Shāstra* or *Śāstra* meaning "rules." They are important within the Hindu tradition—first, as a source of religious law describing the life of an ideal householder and, second, as a symbol of the summation of Hindu knowledge about religion, law, and ethics.

As we saw with the Chinese transplantation and reception of Western-style laws, so too was Hindu law pushed aside beginning with the period of English colonialism in the seventeenth century. But also, as in China where Confucianism continues to play a role in the social and cultural values held by the Chinese people, the values that underlie Hindu law continue to play a role in modern-day India. The English installed the case law system, so just as we sometimes refer to Anglo-American law, we can speak of Anglo-Hindu law. The role of Hindu tribunals and customs-based law, as well as the arrival of common law legislation, diluted the influence of traditional Hindu law. In the nineteenth century, statutes, as well as a criminal law and civil procedure, replaced Hindu contract and property laws. Upon independence in 1949, India retained most of English law but recast it into a **Hindu Code**. More importantly, much of India remains rural; where the old law traditions remain strong, often formal law is ignored and the autonomy of castes is still entrenched in daily life.

Mixed Jurisdictions

This section reviews two of the more important mixed law systems—Scotland and South Africa. Each entity combines features of the civil and common law systems. South Africa still shows strong features of the civil law, due to its earlier colonization by the Dutch, despite being a member of the British Commonwealth. Scots law has a basis derived from Roman law, and combines features of civil law, dating back to the *Corpus Juris Civilis*, common

Table 10.2 Comparison of Four Legal Systems

Characteristics	Civil Law	Common Law	Islamic Law	Socialist Law
Other Names	Continental; Romano-Germanic	Anglo-American; judge-made law	Religious Law; <i>Shari'a</i>	Socialistic
Sources of Law	Codes and Statutes	Cases and Statutes	Religious Documents and Religious case law	Statutes
Role of Judges	Dominant Trial; research and finds evidence; asks questions directly of the witnesses	Neutral, Impartial Referees; Lawyers present evidence and ask questions of the witnesses	Judges play Secondary Role	Judge Dominates the Trial
Judicial Independence	High	High	Varies from Country to Country	Low
Role of Judicial Branch (Courts)	Share Power with Other Parts of Government	Courts have Separate and Equal Power with Other Branches of Government	Historically, Courts are Subordinate to <i>Shari'a</i> law; Modern, Subordinate to Executive Branch	Courts Inferior to Legislative Branch
Countries	All European Union states (except UK and Ireland), All of Continental Latin America (except Guyana and Belize), Quebec, All of East Asia (except Hong Kong), Congo, Azerbaijan, Kuwait, Iraq, Russia, Turkey, Egypt, Madagascar, Lebanon, Switzerland, Indonesia, Vietnam, Thailand	Australia, UK (except Scotland), India (except Goa), Nigeria, Ireland, Singapore, Hong Kong, USA (except Louisiana), Canada (except Quebec), New Zealand, Pakistan, Malaysia, Bangladesh	Many Muslim countries have adopted parts of <i>Shari'a</i> Law. Examples include Saudi Arabia, Afghanistan, Iran, UAE, Oman, Sudan, Malaysia, Pakistan, and Yemen	No Longer in Existence, but still influences the application of law in China, Russia, and some former Soviet-bloc Countries
Use of Juries	Only in Criminal Trials	Trial Level	Allowed by Maliki School of Sunni Islam (countries of Northern Africa)	Sometimes at the Lowest Level of Court System

law, and customary or local law from the High Middle Ages (900–1300). Scotland has been part of the United Kingdom since its 1707 union with England and has increasingly followed the common law.

Scotland

Scotland is part of the United Kingdom of England, Wales, and Northern Ireland. However, Scotland has retained its own legal identity—its own Parliament, legal profession, and court system. Nonetheless, Scottish cases are appealable to the highest English courts. Roman law influenced early Scottish law with the establishment of Scottish law schools in the fifteenth century and the study of canon law. The *Regiam Majestatem* (early fourteenth century), shown in Figure 10.7, is the earliest surviving work on Scottish law. It consists of a comprehensive digest of early Scottish law in four books, treating (1) civil actions and jurisdictions, (2) judgments and executions, (3) contracts, and (4) crimes. But the influence of Roman law on Scottish law is often overstated, with English common law being the major influence on Scottish law since the unification of England and Scotland in the eighteenth century.

The remnants of Roman law produced a rather chaotic body or system of law. This was largely elevated by the “institutional writers” led by Viscount Stair, whose treatise, *The Institutions of the Law of Scotland*, was published in 1681. Stair’s work organized the different sources of Scottish law (customary, feudal, and Roman or canon law) into a coherent system of law.¹⁵ However, beginning in the nineteenth century the overloaded Scottish court system shifted from dealing with each case as unique and moved toward the common law’s rule of precedent, looking more to case law than to Roman law or the works of the institutional writers. In modern times, reforms to English and Scottish law have been coordinated by **Law Commissions**. The Law Commission Act of 1965 established two commissions, the English Law Commission and the Scottish Law Commission. Because of the remaining differences between the English and Scottish laws, the two commissions act in consultation with each other in drafting law and in revising existing laws.

South Africa

South Africa is considered an emerging economy or newly industrialized country with a population of about 50 million people. It was subject to both British and Dutch colonialism. Thus, Afrikaans (Dutch derivative) and English are two of its major languages; however, there are 11 official languages. The Constitution is the supreme



REGIAM MAJESTATEM , LIBER PRIMUS.

PRÆFATIO (a).

*Regi duo sunt necessaria ; Arma , quibus
Hostes debellet ; Leges , quibus Subditos
pacificè regat.*



REGIAM Majestatem , non solùm armis contrà
rebelles , sibi , Regnoque insurgentes , oportet esse
decoratam.

Figure 10.7 *Regiam Majestatem*.

law in the country. The primary sources of South African law are Dutch-Roman commercial law, as well as English common law. The Dutch brought Dutch-Roman law, but this was before the enactment of the French Napoleonic Code, so the Dutch introduced a relatively undeveloped civil law when the British colonized South Africa in the nineteenth century, resulting in a hybrid legal system similar to Scottish law.

South African contract law is primarily based upon Old Dutch law with a fair amount of influence from English common law.¹⁶ This amounted to confusion as to what was required to create an enforceable contract. The common law requires that a contract must be supported by reciprocal *consideration* (exchange of value), while consideration is not required under the civil law. Under the civil law all “serious” agreements are enforceable with or without consideration. Instead, the civil law requires *causa*, which vaguely means there is a recognized purpose or reason for the contract. The *causa* makes an agreement serious and, thus, an enforceable contract. In 1874, Chief Justice Lord Henry de Villiers provided an innovative solution by asserting that *causa* meant that the purpose of the agreement was an exchange of values (consideration).¹⁷ In 1919, the confusion came to end when the court in *Conradie v. Rossouw*¹⁸ held that common law’s doctrine of consideration was not part of South African law. A contract is enforceable as long as the parties show proper *causa*. Unfortunately, the meaning of *causa* still remains a vague, but flexible doctrine.

Transnational Law

A great many of international business disputes are resolved through arbitration. Reputable arbitration associations have been established throughout the world including in Cairo, China (Center for International Economic Trade and Commerce), London (International Court of Trade), Moscow, Paris (**International Chamber of Commerce**), Stockholm, and the United States (American Arbitration Association). Unlike courts that must follow mandatory national laws, arbitration tribunals often use international sources of law, such as business customs, usage, commercial practice, as well as international model laws (UNIDROIT Principles of International Commercial Contracts, Principles of European Contract Law, and the European Common Frame of Reference). Arbitrators see their role not so much as the application of law but as rendering “fair and equitable” decisions. As such, they use numerous sources of laws that together have been called transnational law or the new *lex mercatoria*.

An autonomous new *lex mercatoria* or transnational commercial law is a separate category of legal system beyond the traditional dichotomy of domestic or national laws and public international law (treaties, free trade agreements, WTO rules). The make-up of the *lex mercatoria* include: (1) general principles of law, derived from a comparative analysis of the common core of domestic legal systems; (2) the usages and customs of the international business community as expressed in standard form contracts, model clauses, and trade manuals (industry standards); and (3) decisions of international commercial arbitration panels. Many of its rules are found in lists of principles, rules and standards, codes of conduct, or best practices of trade associations and nongovernmental organizations.¹⁹ Its enforcement rests predominantly on social sanctions such as reputation and exclusion from the business community.

The **privatization of lawmaking** is seen in the non-legislative codifications of general principles of law, as well as private codifications of trade usage and commercial custom promulgated by non-state actors. The most important examples of the former are the **UNIDROIT Principles of International Commercial Contracts (PICC)**. Prominent examples for the latter are the International Commercial Chamber’s **INCOTERMS** (trade terms) and the **Uniform Customs and Practice for Documentary Credits (UCP)**, both drafted and continuously revised by the ICC. For a review of INCOTERMS, see Chapter 14 on “Documentary Transactions,” and for a discussion of the UCP, see Chapter 15 on “International Trade Finance.” As these instruments aspire to express uniform rules for international commerce not attached to any specific state legal system, they form part of a transnational commercial law.

Lex Mercatoria and Arbitration

As noted above, the growing importance of transnational rules in international contracts is related to the importance of international commercial arbitration as the premier means of dispute resolution in international business

transactions. Parties negotiating international contracts will often feel the need to submit their agreement to neutral rules, which do not favor either of the parties. A traditional compromise solution, which is frequently used in international trade, consists in submitting the contract to the law of a third country, choosing well-respected commercial laws such as English or Swiss law. This solution is certainly more balanced than the choice of the law of the country of one of the two parties, since it gives neither of them the advantage of having recourse to their own laws.

Since it is rare that parties have a working knowledge of the law of another country (and because they will typically not have time to verify whether the contract fully complies with such law), businesspeople and their legal advisors have become increasingly interested in transnational rules. These rules allow them to create an alternative neutral legal framework for their international contracts. The theory of *lex mercatoria* is an alternative response to the demand to have international contracts governed by national law. According to this theory, international contracts can be ruled by an “a-national” system of principles and rules generally accepted in international commerce. These rules can be found in the industry-specific contract practices, clauses commonly used in international commercial contracts, and in the general principles of international business law. Arbitration practice has evolved the principle that arbitrators have the right to apply general principles of the *lex mercatoria* instead of national laws.

Article 21(1) of the ICC arbitration rules states the following:

Applicable rules of law: The parties shall be free to agree upon the rules of law to be applied by the arbitral tribunal to the merits of the dispute. In the absence of any such agreement, the arbitral tribunal shall apply the rules of law, which it determines to be appropriate.

Arbitration decisions have recognized that when the contract in dispute selects a country’s law as the law of the case (choice of law clause), the *lex mercatoria* may still be used even when it conflicts with the chosen law. An International Arbitration Court at the Chamber of Commerce and Industry of the Russian Federation decided a case concerning a contract between a Russian and a German company. It held that possible disputes should be decided in conformity with the *lex mercatoria* despite the existence of a clause choosing German and Russian law. In an arbitral award on December 22, 2004, the Tribunal of International Commercial Arbitration at the Ukrainian Chamber of Commerce and Trade, concerning a sales contract, applied the CISG, the *lex mercatoria*, and the UNIDROIT Principles in deciding the case. This application of multiple sources of hard law (CISG) and soft law (*lex mercatoria*; UNIDROIT Principles) is common in international arbitration.

Soft versus Hard Law: Soft law refers to rules that are neither strictly binding in nature nor completely lacking legal significance. In the context of international law, soft law refers to guidelines, policy declarations, or codes of conduct, which set standards of conduct. However, they are not directly enforceable. Hard law refers to binding laws. In the context of international business law, hard law includes national laws, as well as treaties and other international agreements.

Despite arbitration panels’ greater flexibility in using hard and soft laws, they will feel bound to follow a country’s law chosen by the parties. However, sometimes the parties fail to insert a choice of law clause in their contract, leaving the arbitrators with a decision to use a hard law (national law) or soft law. Here are the common approaches to this issue used in arbitration:

- 1 Arbitral panels or tribunals will not apply *lex mercatoria* if the parties have expressly chosen a domestic (national) law.
- 2 There is nevertheless some space for supplementing inadequate domestic laws through the referencing of general principles, such as the UNIDROIT Principles and trade usages, but only to the extent this is admissible under the applicable domestic law.

- 3 If the parties have chosen a domestic law as the applicable law together with transnational rules, arbitrators have greater discretion (as compared to courts) when deciding on possible conflicts between the transnational rules and the applicable law.
- 4 In some cases, arbitrators may apply the *lex mercatoria* instead of a domestic law when the parties have made no choice of the applicable law.

In the last case (no choice of law clause), arbitration panels will commonly determine which country's law is closest to the case and apply that law. However, in the famous case of this kind, the *Norsolor* case,²⁰ the arbitrators applied the *lex mercatoria* in a dispute regarding the termination of a contract between a French seller and a Turkish agent. The agent claimed damages for the goodwill developed on behalf of the seller during the contract. However, the right to receive such damages was recognized by French law but not by Turkish law. The arbitrators decided that selecting one of the two national laws through conflict of law rules was not an adequate solution and decided as follows:

Faced with the difficulty of choosing a national law the application of which is sufficiently compelling, the Tribunal considered that it was appropriate, given the international nature of the agreement, to leave aside any compelling reference to a specific legislation, be it Turkish or French, and to apply the international *lex mercatoria*.

In the context of the *lex mercatoria* the tribunal applied the **principle of good faith** and awarded damages to the agent. In several other cases the arbitrators applied *lex mercatoria* or general principles of law when it appeared that neither party wanted to apply the other party's law or when the parties expressed the desire to have the dispute decided on the basis of non-state rules by stating that disputes shall be decided, for instance, through reference to international law or "according to the laws of natural justice."

Another interesting example is the *Arthur Andersen* case,²¹ where the arbitration clause provided, with respect to the applicable law, the following:

The arbitrator shall decide in accordance with the terms of this Agreement and of the Articles and Bylaws of Andersen S.C. In interpreting the provisions of this Agreement, the arbitrator shall not be bound to apply the substantive law of any jurisdiction but shall be guided by the policies and considerations set forth in the Preamble of this Agreement and the Articles and Bylaws of Andersen, S.C., taking into account *general principles of equity*.

The sole arbitrator decided to apply the general principles of law and the general principles of equity commonly accepted by the legal systems of most countries. He concluded that the UNIDROIT Principles was "a reliable source of international commercial law in international arbitration."

Chapter Summary

- 1 National laws are a product of a given legal tradition, which shapes how the role of law is viewed by society, as well as the reach and scope of law. Legal traditions not only determine substantive law, but also the ways that legal claims are processed by the legal system, the role of lawyers, the role of judges, the role of juries, and the types of remedies and the size of damages given. These concerns are of central importance in international transactions, especially when the contracting parties are from different legal systems. Businesspersons try to reduce the risks of the application of foreign laws through the insertion choice of law, forum selection, and arbitration clauses into their contracts.
- 2 The typology of comparative law breaks down the laws of the world into legal traditions, legal families, and national legal systems. *Legal traditions* are bodies of law that have a unique history and are often a product of cultural norms and in which most national laws are categorized as being within a handful of legal

traditions. The legal traditions covered in this chapter are the civil law, common law, Islamic, Hindu, Chinese law, and mixed jurisdictions (Scotland and South Africa). The laws of the United Kingdom (excluding Scotland), United States, and Australia are of the common law tradition. The laws of France, Germany, and Turkey are of the civil law tradition. *Legal families* are the grouping of different countries within the same legal tradition. The civil law tradition is divided into countries of the Franco-Romanic or Napoleonic and Germanic legal families. The French and German Civil Codes have heavily influenced the civil laws of other countries. *National legal systems* include the study of countries' legal systems that are part of the same legal tradition or legal family. The fact that two countries are part of the same tradition or family does not mean that there are no substantial differences between the countries. The United Kingdom and the United States are both common law countries but have been independent national systems for over 230 years. As such, despite a great deal of commonality, the two laws have evolved in different ways. France and Germany are both part of the civil law tradition, but their civil codes are often compared because of their numerous differences. Finally, French and Spanish laws are part of the Franco legal family, but also display significant differences.

- 3 Comparative law examines the differences between legal systems. It also analyzes the influences that one or more legal systems have had on other legal systems through the processes of reception and legal transplantation. Examples of such transborder influences and borrowing are China and Vietnam. Modern-day Chinese contract law is a product of influences from international sales law (CISG), international "soft law" (UNIDROIT Principles), German law, Soviet-socialistic law, as well as common law. Vietnamese law is a product of Chinese, French colonial, socialist, and Western laws.
- 4 The world's two major legal traditions are the civil and common laws. The civil law evolved in continental Europe out of Roman law, especially as espoused in the *Corpus Juris Civilis* (Justinian Code). The common law evolved from the High Middle Ages as the customary law of England. The major difference between the two is the source of their laws—civil law is code or statute based, while common law is based on judge-made decisions through the law of precedent (*stare decisis*). The traditions also differ regarding the role of judges, juries, and lawyers; the types of legal reasoning used; and the role of legal scholarship in judicial decision-making.
- 5 Islamic law is based on religious law as represented by *Shari'a* law. Technically, *Shari'a* law impacts all facets of life, but it is mostly dedicated to how people of the faith should live their lives and focuses on morality, religious practices, and conduct. One example of the impact of the *Shari'a* on international law is the increasing influence of Islamic finance or banking law in which charging interest (*riba*) is considered a violation of Islamic law. Most of the Islamic law countries have Western-style civil and commercial codes to govern business practices.
- 6 With the advent of the free trade area and the proliferation of international trade, there has been a development of transnational law and the *lex mercatoria* that transcends national legal systems. Transnational law is a blend of hard law (mandatory) and soft law (non-mandatory business customs and general principles). The Convention on Contracts for the International Sale of Goods (CISG) is an example of hard transnational law because over 80 countries have adopted it. Soft law in the form of business practices or trade usage is exemplified by manuals issued by the International Chamber of Commerce in Paris in the areas of trade terms (INCOTERMS) and rules relating to letters of credit (UCP). The fact that arbitration is the preferred means of dispute resolution in international business has been a major force in developing transnational law.

Key Terms

Analogical Reasoning
Anglo-American Law
Arbitration Clause

Better Rules (comparative law)
British Commonwealth of Nations
Bürgerliches Gesetzbuch (BGB)

Canadian Legal System
Chinese Contract Law (CCL)
Choice of Law Clause

Civil Law Tradition	Hindu Code	<i>Quran</i>
Common Core (comparative law)	Hindu Legal Tradition	Principle of Good Faith
Common Law Tradition	<i>Ijma</i>	Privatization of Lawmaking
Conflict of Laws	INCOTERMS	<i>Ratio Decidendi</i>
Confucianism	<i>Institutions of the Law of Scotland</i>	<i>Regiam Majestatem</i>
Convention on Contracts for the International Sale of Goods (CISG)	International Chamber of Commerce	<i>Riba</i>
<i>Corpus Juris Civilis</i> (Justinian Code)	Islamic Banking	Roman Law
Courts of Chancery	Islamic Legal Tradition	<i>Shari'a</i> Law
Customary Law	Law Commissions (English and Scottish)	<i>Shastra</i>
Deng Xiaoping	Law of Precedent	<i>Stare Decisis</i>
<i>Dharma</i>	Legal Family	Stated-Owned Enterprises (SOEs)
<i>Dicta</i>	Legal System	Statute of Westminster
Draft Chinese Civil Code	Legal Transplantation	<i>Sunna</i>
<i>Erie</i> Doctrine	<i>Lex Mercatoria</i>	Talmudic Legal Tradition
Forum Selection Clause	Magna Carta	<i>Tang</i> Code
Franco Legal Family	Mixed Jurisdiction	Transformation of Law
French Civil Code	<i>Napoleonic Code</i> (<i>Code Napoléon</i>)	Transnational Law
Germanic Legal Family	<i>Qing</i> Code	UNIDROIT Principles of International Commercial Contracts (PICC)
<i>Guanxi</i>		Uniform Customs and Practices for Documentary Credits (UCP)

Chapter Problems

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|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>1 What are the major legal traditions in the world, and what are their distinctive characteristics?</p> <p>2 How do a country's cultural values and practices affect its legal tradition? How does a country's culture impact the role of law in society? How does culture impact on private parties' use of the courts and legal system? Most importantly, how do cultural values and the view of the role of law (especially the role of contracts) determine how you should engage a possible business partner in another country?</p> <p>3 What roles does Confucianism play in modern-day China? How does its influence affect the negotiation and drafting of contracts?</p> <p>4 How is the common law different from the civil law? Statutes have proliferated in both common and civil law countries, so how can it be said that the common law is judge-made law? What is the difference between the role of statutes in the common versus the civil law?</p> | <p>5 Connect the items on the left with the terms that are most clearly related on the right (answers over the page):</p> <hr/> <table border="0"> <tr> <td style="vertical-align: top;"> <p>i Legal Tradition</p> <p>ii Legal Family</p> <p>iii Legal System</p> <p>iv <i>Corpus Juris Civilis</i></p> <p>v Writs</p> <p>vi Sunna</p> <p>vii "Face-saving"</p> <p>viii Courts of Equity</p> <p>ix <i>Qing</i> Code</p> <p>x Napoleonic Code</p> </td> <td style="vertical-align: top;"> <p>a. social and legal customs and practices</p> <p>b. specific performance and injunction remedies</p> <p>c. Chinese criminal code</p> <p>d. Codification of Roman law</p> <p>e. Canadian law</p> <p>f. French Civil Code</p> <p>g. Germanic-Roman law</p> <p>h. Civil law</p> <p>i. Old English law</p> <p>j. Asian cultural value</p> </td> </tr> </table> <hr/> | <p>i Legal Tradition</p> <p>ii Legal Family</p> <p>iii Legal System</p> <p>iv <i>Corpus Juris Civilis</i></p> <p>v Writs</p> <p>vi Sunna</p> <p>vii "Face-saving"</p> <p>viii Courts of Equity</p> <p>ix <i>Qing</i> Code</p> <p>x Napoleonic Code</p> | <p>a. social and legal customs and practices</p> <p>b. specific performance and injunction remedies</p> <p>c. Chinese criminal code</p> <p>d. Codification of Roman law</p> <p>e. Canadian law</p> <p>f. French Civil Code</p> <p>g. Germanic-Roman law</p> <p>h. Civil law</p> <p>i. Old English law</p> <p>j. Asian cultural value</p> |
| <p>i Legal Tradition</p> <p>ii Legal Family</p> <p>iii Legal System</p> <p>iv <i>Corpus Juris Civilis</i></p> <p>v Writs</p> <p>vi Sunna</p> <p>vii "Face-saving"</p> <p>viii Courts of Equity</p> <p>ix <i>Qing</i> Code</p> <p>x Napoleonic Code</p> | <p>a. social and legal customs and practices</p> <p>b. specific performance and injunction remedies</p> <p>c. Chinese criminal code</p> <p>d. Codification of Roman law</p> <p>e. Canadian law</p> <p>f. French Civil Code</p> <p>g. Germanic-Roman law</p> <p>h. Civil law</p> <p>i. Old English law</p> <p>j. Asian cultural value</p> | | |

Internet Exercises

- 1 Review the following sources to gain a better understanding of Roman law: <https://www.law.berkeley.edu/library/robbins/RomanLegalTradition.html> (Roman Legal Tradition and the Compilation of Justinian); <http://romanlegaltradition.org> (Roman Legal Tradition). See also, Franz Wieacker, “The Importance of Roman Law to Western Civilization and Western Legal Thought,” 4 *Boston College International and Comparative Law Review* 257 (1981) (available at <http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1585&context=iclr>).
- 2 Make a list of countries that you are unsure have what type of legal system and go to: “Listing of Legal Systems” in the CIA World Factbook at <https://www.cia.gov/library/publications/the-world-factbook/fields/2100.html#136>.

Other Internet Sources

CIA Maps: Page-sized base maps are in the public domain. Accordingly, they may be copied freely without permission of the Central Intelligence Agency (CIA): <https://www.cia.gov/library/publications/resources/cia-maps-publications>.

World Legal Systems: <http://www.juriglobe.ca/eng/index.php> (University of Ottawa).

[Answers to Problem 5: i (h); ii (g); iii (e); iv (d); v (i); vi (a); vii (j); viii (b); ix (c); x (f)]

Notes

- 1 See Larry A. DiMatteo, “Principle of Fair and Equitable Decision-Making in International Contract Arbitration and Its Affinity to International Soft Law,” 1 *Chinese Journal of Comparative Law* 1 (2013).
- 2 The United States is not a member of the 53 members of the British Commonwealth, mostly all of which had been colonized as part of the British Empire. The United States is the only former colony country that obtained independence through revolution.
- 3 See, e.g., H. Patrick Glenn, *Legal Traditions of the World* 125–169 (2nd ed. 2004).
- 4 Mathias Siems, *Comparative Law* 191–220 (2014) (Chapter 10: “Legal Transplants”).
- 5 John Gillespie, *Transplanting Commercial Law Reform* (Ashgate 2006).
- 6 Alan Watson, *Legal Transplants: An Approach to Comparative Law* 20 (1974).
- 7 See Patricia Pattison and Daniel Herron, “The Mountains are High and the Emperor is Far Away: Sanctity of Contract in China,” 40 *American Business Law Journal* 459 (2003).
- 8 H. Patrick Glenn, *Legal Traditions of the World* 131 (2nd ed. 2004).
- 9 *Ibid.* at 134–135.
- 10 163 U.S. 537 (1896).
- 11 347 U.S. 483 (1954).
- 12 See Richard Yates, *Legal Fundamentals for Canadian Business* (3rd ed. 2013); John A. Willes and John H. Willes, *Contemporary Canadian Business Law* (11th ed. 2015).
- 13 Daniel Chow, *The Legal System of the People’s Republic of China* (2nd ed. 2009).
- 14 Gamal Moursi Badr, “Islamic Law: Its Relation to Other Legal Systems,” 26 *American Journal of Comparative Law* 187 (1978).
- 15 Robin White and Ian Willock, *The Scottish Legal System* (2nd ed. 1999).
- 16 See, *The Law of Contract in South Africa* (2nd ed., eds. D. Hutchinson and C. J. Pretorius 2012).
- 17 *Alexander v. Perry* (1874) 4 Buch 59.
- 18 1919 AD 279.
- 19 Graft-Peter Calliess, “Lex Mercatoria,” 52 *ZenTra Working Papers in Transnational Studies* (April 2015).
- 20 ICC arbitral award 3131/1979, *Pabalk Tikaret Limited Sirketi c. Norsolor S.A.*, in JARVIN, DERAIS, *ICC Awards 1974–1985*, p. 122.
- 21 *Andersen Consulting v. Arthur Andersen Business*, ICC International Court of Arbitration, Case No. 9797, available at <http://www.unilex.info/case.cfm?id=668>.

COMPARATIVE AND INTERNATIONAL CONTRACT LAW

Thorough knowledge of substantive law rules and principles is imperative in drafting a good contract. At the domestic level, a working knowledge of the **Uniform Commercial Code (UCC)** provides a solid foundation for drafting a sales contract. At the international level, however, the general principles of contract law are less specific and are applied sporadically by national courts. Thus, it may be necessary to know the law of the country of your foreign contracting party in order to avoid misunderstandings. Cultural and language differences, however, may prevent a contract from ever being formed. Knowledge of the other party's culture and negotiating style is important if an initial inquiry is to develop into a long-term contractual relationship.

Business behavior differs among cultures. Some cultures focus on the importance of developing a contractual and social relationship and not on the importance of the deal as is prevalent in the United States. Many cultures view a formal, detailed contract as unnecessary and hindering a good faith, evolving contractual relationship where the parties mutually work through problems. "For many Asian cultures the contract may not represent finality but a starting point of a relationship. It is assumed that the contract will be reexamined, reinterpreted, or renegotiated if conditions change. In these more traditional cultures, negotiators seek mainly broad-based agreements that are general, flexible, and implicit."¹ In contrast, U.S. businesspersons view a contract as the operative tool for ensuring full and complete performance—something that should be honored at any cost.

Many foreign cultures view the negotiation phase of contracting as one in which a relaxed development of the relationship should be pursued. This is in opposition to the U.S. "time is money" approach. Without a firm understanding of the cross-cultural differences in negotiating styles, the likelihood of successful completion of the negotiations is greatly diminished. This chapter will review some of the cultural nuances in negotiating a contract in an international setting with a focus on Japan. It will then shift focus to the nuances of substantive contract law at the national and international levels with a particular emphasis on the area of precontractual liability.

Negotiating an International Contract

Misunderstandings in the negotiation of a contract may be caused by differences in language (nontranslatable words and concepts); however, they may also be due to "how" the words are communicated. Often parties read content into words based upon the surrounding circumstances; meaning is attributed to how something is stated rather than on the actual meaning of the words. In high-context cultures, meaning is much more constructed from the way the words are used (context) than the meaning of the actual words used—meaning is based upon what is understood rather than the actual meaning of each word. The United States and Germany are low-context cultures, while Japan, Latin America, and Arabic cultures are high-context cultures. Thus in a high-context culture there is greater reliance on nonverbal cues, silence is respected, attention to detail is not highly valued, and words are not always given their literal meanings.

As will be noted below, relationship building is more important in some cultures than the actual details of the contract. In the same vein, respect and reputation are highly valued. Thus, in such cultures, if something is taken as a lack of respect or a party is seen as "losing face," the likelihood of a successful negotiation is unlikely. The United States is an example of a low face-saving culture where negotiations are more likely to continue; while China and

Japan are high face-saving cultures where negotiations are likely to be terminated. In the latter types of cultures, the foreign negotiator should be polite and respectful, patient in the negotiations, willing to socialize, not overly direct, and not obsessed with detail.

The differences in negotiating styles are attributable to different cultures' view of the role of law. In Chinese and Japanese cultures, shame and bad reputation are considered serious sanctions. In U.S. culture, litigation is more quickly resorted to, while litigation is disfavored in China and Japan. At times, in these countries, litigation may not be pursued even in meritorious cases if the party views pursuing litigation will have a negative effect on its reputation. This is also the reason that the actual contracts and the rights they bestow are less important than maintaining a healthy relationship. For the Japanese, contracts should be win-win scenarios rather than zero-sum (win-lose) scenarios. The zero-sum scenario views the role of contracting negotiations as obtaining the most one-sided contract possible. Win-win scenarios view contract negotiations as maximizing benefits for both parties. See Table 11.1 "Negotiating Styles and Cultural Traits" to see some of the generalized cultural traits and negotiating styles in Arabic countries, Brazil, China, Japan, and Russia.

The descriptions in Table 11.1 are highly generalized and can vary from company to company, region to region, and, in the case of Arabic countries, from country to country. For example, the Japanese have learned the Western view of the importance of the written contract. Therefore, the length and detail of a contract will be different between two Japanese companies and a Japanese and Western company. In the Arabic world, the role of *Shari'a* on commercial transactions varies from country to country.

Cultural awareness is vital before beginning the negotiation of a contract with a foreign party, especially when that country is from a different cultural tradition. Cultural awareness at the minimum includes the appropriate way to greet another party, common courtesies expected in social interactions, business ethics, decision-making practices, formalities, and proper business attire, and, unfortunately, in some countries there may be gender issues. An example of each of the above listed items will be given here. (1) Greetings in some countries may be oriented to "bowing" instead of handshaking. (2) In some cultures, a dinner begins with a toast (alcohol) and during the dinner a party may go around the table to toast with individuals directly; this is a sign of respect and to refuse would be a breach of etiquette. (3) Some cultures have the practice of gift giving, which may be considered illegal or unethical in other cultures. (4) In some cultures the person you are negotiating with may not be the person who makes the decisions; in some cultures, no one person makes a decision but decision-making is done through consensus building. (5) It may be best to keep a formal, more respectful approach when first meeting a person; it is best to let the other person decide when a more informal, casual relationship is in order. (6) In some cultures what one may consider to be an informal event may still require formal attire. The most problematic cultural trait is signs of racial and gender bias. Despite your personal distaste for such biases it is not your place to show signs of disapproval depending on your managerial level within the company. Do not assume that the biases of the negotiating party reflect or define the views of the country or its people.

Table 11.1 Negotiating Styles and Cultural Traits

<i>Countries</i>	<i>Relationship vs. Contract Focused</i>	<i>More or Less Detail Oriented</i>	<i>Direct vs. Indirect Bargaining</i>	<i>Win-Lose vs. Win-Win</i>	<i>Cultural Traits</i>
Arabic	Relational	Less	Indirect	Win-Lose	Role of women in negotiations is restricted; influence of religious law
Brazil	Contract	Less	Both	Win-Lose	Not reluctant to reject proposals
China	Relational	Less	Indirect	Win-Win	More approvals needed leads to longer negotiations; transaction should benefit the State
Japan	Relational	Less	Indirect	Win-Win	Consensus-building within company to approve contract; formality and courtesy important
Russia	Relational	Medium	Direct	Win-Lose	Not as trusting of the rule of law; do not question authority

The substantive laws and commercial means of doing business are amazingly similar among the world's different legal systems, but the differences in negotiating styles and contract customs are profound. For example, even though the importance of a written contract is universally recognized in principle, executing a long, detailed contract may be frowned upon in some countries. "In many cultures, if one is required to write down the agreement, it will destroy the trust and render the agreement invalid."² International contract negotiation is a very difficult and complicated affair; the nuances of language and culture make it risky for the unsophisticated importer or exporter. The negotiation of the export or sales contract is generally more time-consuming than in a domestic transaction because foreign contractors need to develop a trust in their U.S. counterpart before entering into a contract. It is important for the U.S. businessperson to understand these cultural differences.

The added time invested to negotiate an international contract carefully will provide significant dividends in the long term. First, an agreement that successfully overcomes language, cultural, and legal differences will better reflect basic understandings and minimize misunderstandings. For example, it is difficult for U.S. businesspersons "to realize that in some countries, especially in Asia, it is characteristic for a businessperson to speak in vague terms with nuances that only experience can help decipher." Second, the trust developed during the negotiation stage often sets the foundation for a long-term international business relationship.

The following excerpt discusses some of the nuances associated with Japanese negotiators and business practices:

*The story about Japanese contracting that emerges is that law is largely irrelevant. Instead, the business relationship is paramount, and the Japanese favor unwritten, or very brief agreements; do not regard themselves bound by the letter of such agreements but rely on the notion of changed circumstances to seek renegotiation; and, in the case of a dispute, will seldom, if ever, allow the matter to proceed to court. The relationship, rather than the formalities or potential legal sanctions, traditionally gave the contract its binding force in Japan. Commercial custom in contemporary Japan often revolves around transaction types identified as traditional contracting practices. My personal favorite is the cry-yourself-to-sleep transaction, in which the seller is faced with a sudden cancellation of an order and simply absorbs the consequent loss, in the hope that it will be made up in the future. Classical contract law supports not all of these practices, but all represent commercial expectations, and to that extent, they can be viewed as a kind of unwritten law. In Japan, a continuing contract will invite some relational analysis. Specifically, it is not improbable that a court would seriously consider the effect of removing a retailer as *ikigai* (reason for living) as well as the legal merits and economic rationality of a termination.³*

Such cultural differences have crucial practical importance in the negotiation and formation of a contract. The Confucian influence of harmony permeates contracting in Japan. Thus, the U.S. style of hard bargaining and pressure tactics is likely to meet with failure. It is important to state a position firmly and at the same time not disturb the *wa* or harmony of the negotiation. The Japanese aversion to litigation stems from the belief that it is their societal "duty to avoid discord."⁴ Interestingly, the Japanese also dislike arbitration. They believe that parties should negotiate directly in resolving disputes. In case of failure in negotiating a solution, the Japanese prefer the use of conciliation or *chotei*.

The concept of *wa* is reflected in the Japanese approach to negotiation as the process of developing a trusting business relationship and not the simple formation of a contract. (See Figure 11.1 *Doing Business Internationally: "Contract Characteristics in Japan."*) From a practical perspective, this results in Japanese contracts being simple, short, and vague. All problems are to be dealt with through acts of conciliation. All questions are to be answered through a process of *reconcilement*, which is a process where parties negotiate adjustments to the contract in order to restore the *wa* or harmony into their relationship. The contract provides a basic framework that allows for modification and flexibility. Performance standards are not defined restrictively. Thus, the U.S. businessperson may have to modify his preference for long, detailed agreements.

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| <ul style="list-style-type: none"> • “Contract” assumes not opposition of parties, but cooperation. • Parties attach more importance to establishing a collaborative human relationship than preparing a highly formal, legalistic written contract. • Contract provisions are written not to be rigid, but to be flexible and changeable. • Parties prefer clauses that in case of changed circumstances require the parties to act in good faith to renegotiate the term, rather than including detailed clauses to cover anticipated disputes. | <ul style="list-style-type: none"> • Contracts generally are simple, consisting of a few short clauses. • There is an implied understanding that clauses are to be applied leniently in the area of performance. • In case of dispute, the preferred means of resolution is the giving of mutual concessions and not litigation. • To conclude a negotiation often means not to sign a written contract, but to establish a personal and cordial relationship. |
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Figure 11.1 *Doing Business Internationally*: Contract Characteristics in Japan.

Source: Shoji Kawakami, “Precontractual Liability: Japan” in *Pre-contractual Liability: Reports to the Eleventh Congress of the International Academy of Comparative Law* 205–21 (Ewoud H. Hondius ed. 1991).

Cultural differences can have a profound impact on new business relationships. The U.S. exporter should be careful in how he approaches a prospective contact in Japan. The Japanese place a high premium on personal contact; a Japanese importer may not respond to written inquiries. Therefore, any initial inquiry should be followed by a personal contact. The best approach is to ask to be introduced by an intermediary known to the other party.

Another possible conflict resulting from cultural differences comes from the U.S. businessperson’s propensity to send a written agreement when negotiations have entered into their final stages. A U.S. businessperson may ask his attorney to confirm the terms discussed and agreed upon before the negotiations are complete. The lawyer may respond by sending a letter or a proposed agreement to the other party. “But the letter may get no response because the unexpected arrival of a contract probably appears abrupt and possibly coercive to a foreign recipient.” In order to avoid cultural *faux pas*, one attorney gives this advice:

Do some reading on the country—at least you’ll know where it is. Know something of the history. Talk to someone who’s done business there, an American businessman or someone from the Department of Commerce—find out who the trade specialist is in that country and talk to that person. And once you get there, don’t hop off the plane and set up meetings. . . . Don’t do the trilogy of hotels, restaurants, and office buildings. Instead of staying in your hotel room answering e-mail, get up in the morning and walk around.

It is important to understand the authority of the other negotiating party and her place in the chain of command. A longer negotiation period may be due not to the other party’s reluctance or gamesmanship but to her lack of authority to complete a deal on her own. For example, the Japanese often make business decisions based upon a consensus or *ring-sho*, which takes time to formulate.

A number of criteria must be satisfied in order for cross-cultural contract negotiations to conclude successfully. First, the negotiations should lead to a written contract that is enforceable in the countries of both parties. Second, conflicts that result from cross-cultural misunderstandings are avoided through a carefully negotiated and written contract that informs both parties of their rights and duties. A full understanding of rights and duties provides the basis for the development of a strong business relationship. Third, dispute resolution should be completely and fairly addressed in the contract. Because of the cost, inconvenience, and uncertainty of transnational litigation, the contract should outline cost-effective and relationship-preserving means of dispute resolution. Some countries, such as China and Japan, have long emphasized conciliation without resort to litigation as the preferred manner of dispute resolution.

Appropriate contract provisions will minimize the risks of international business dealings addressed in Chapter 1. Special attention should be devoted to the issue of “changed circumstances,” since various legal and business

cultures deal with this issue differently. U.S. culture places a premium on the strict enforcement of contractual rights and duties regardless of circumstance. In contrast, some other cultures will not strictly enforce a contract if there has been a change in circumstances. Therefore, the contract should deal carefully with issues of renegotiation and modification of the contract in the event of such changes.

Principles of International Contract Law

Despite the differences in how foreign laws and deal with the negotiation, interpretation, and enforcement of contracts, there are tremendous similarities among the different legal systems in how the law supports commercial transactions. For example, the civil law and common law legal systems provide similar mechanisms for facilitating business transactions. Most differences are a matter of style and not substance.

Along with the similarities among legal systems in commercial law, a trend has been evidenced toward developing a unified body of international business law. This trend can be seen at work on a number of different levels. First, the growth of **customary international business law** is seen with the almost universal adoption of the International Chamber of Commerce's standards in the area of trade terms (**INCOTERMS**; see Chapter 14) and letters of credit (Uniform Customs and Practices for Documentary Credits or UCP; see Chapter 15). Second, the increased publication and citation of international commercial arbitration decisions are evidence of the development of an international commercial jurisprudence not tied directly to national laws. Finally, there have been important developments in the enactment of international treaties and conventions unifying international business law. The clearest example of this trend was the ratification of the United Nations Convention on Contracts for the International Sale of Goods on January 1, 1988. This pioneering effort to unify international sales law will be the subject of Chapter 12, "International Sales Law." For examples of international private law conventions see Figure 11.2 *Comparative Law*: "International Commercial Law Conventions."

It is impossible to adequately draft a contract without knowledge of substantive contract law. The need is compounded when drafting an international contract where there are at least three possible sources of law, including the national laws of each of the parties and international contract law or the *lex mercatoria*. The *lex mercatoria* or "law of merchants" refers to business customs or trade usage developed by businesspersons throughout the world in order to facilitate business transactions. Some degree of *harmonization* has been achieved through the adoption of international conventions. These conventions often become enacted into national law or become a part of the *lex mercatoria*. The ideal situation is to have a working knowledge of trade usage, law of the seller, and law of the buyer, including any relevant international conventions.

Even if the contract writer attempts to reduce his need to know a foreign law by using a choice of law clause, he still must be knowledgeable about the mandatory or immutable rules and regulations found in the foreign law. Also, arbitrators often resort to a supranational law or *lex mercatoria* in place of a full application

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| <ul style="list-style-type: none"> • United Nations Convention on Contracts for the International Sale of Goods, ratified January 1, 1988 • United Nations Convention on the Limitation Period of the International Sale of Goods, ratified January 1, 1988 • UNCITRAL (United Nations Commission on International Trade Law) Independent Guarantees and Stand-by Letters of Credit • United Nations Convention on Carriage of Goods by Sea (Hamburg Rules, ratified 1992) • United Nations Convention on Multimodal Transport | <ul style="list-style-type: none"> • UNIDROIT (International Institute for the Unification of Private Law, or Rome Institute) Convention on International Financial Leasing • UNIDROIT Convention on International Factoring • UNIDROIT Principles of International Commercial Contracts • United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention) • UNCITRAL Model Law on International Commercial Arbitration |
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Figure 11.2 *Comparative Law*: International Commercial Law Conventions.

of a national law designated by a choice of law clause. Danish professor Ole Lando listed the following seven sources⁵ of the *lex mercatoria* that can be used in the interpretation of contracts:

- *Public International Law*: There are provisions in the Vienna Convention on Treaties that can be applied to private international contracts.
- *Uniform Laws*: The Hague Rules (codified as COGSA) and the Convention on Contracts for the International Sale of Goods (CISG) are examples of successful attempts at uniform international laws.
- *General Principles of Contract Law*: The best example of a general principle of contract law found in most national legal systems is *pacta sunt servanda* or what is referred to in the common law as *sanctity of contract*.
- *Rules of International Organizations*: Courts may look to nonbinding rules published by such international organizations as the United Nations, Organization for European Cooperation and Development (OECD), and the International Institute for the Unification of Private Law (UNIDROIT).
- *Custom and Usage*: The clearest examples of custom and usage or *customary international law* that has reached a level of almost universal acceptance are the standards and rules published by the International Chamber of Commerce in the area of trade terms (INCOTERMS) and letters of credit (Uniform Customs and Practices for Documentary Credits, or UCP).
- *Standard Form Contracts*: Once again, the ICC is a good source for standard form contracts and standard clauses. For example, the ICC publishes standard or model forms of Distribution and Agency Agreements. They also publish a manual to be used in the drafting of *force majeure* and hardship clauses.
- *Arbitral Decisions*: Although not widely reported, arbitral decisions provide an outstanding resource for principles.

Generally recognized international contract principles have a direct bearing on how one approaches the drafting of an international contract. These principles are brought to bear by courts and arbitration panels in the interpretation of contracts. They are also used to determine the parties' rights and duties regarding performance and subsequent requests for adjustments in the contract. The general principle is that contracts should *prima facie* be enforced according to their terms under the doctrine of *pacta sunt servanda*. However, *pacta sunt servanda* is also qualified by the concept of *abus de droit*—the rule that unfair or unconscionable contracts and clauses should not be enforced.

The general duty of good faith in international contracting is a more expanded version of the good faith requirement found in the United States. The civil law concept *culpa in contrahendo* requires that the parties negotiate in good faith. This civil law concept will be fully explored later in the chapter. The U.S. concept of good faith is applied only to the area of performance and enforcement of contractual obligations. Thus, in international contracting there is a possibility of liability before the conclusion of a contract. The principle of good faith is further extended to a duty to adjust the contract in the event of unforeseen circumstances.

The notion of good faith should guide the U.S. businessperson's response to all communications from a foreign party. Failure to respond to a letter or request is often regarded as evidence of assent to its terms. This concept can be seen at work in the **Convention on Contracts for the International Sale of Goods (CISG)** adoption of *nachfrist notice*, in which a party makes a request for additional time to perform. In the event that the receiving party fails to respond or fails to give a commercially viable reason for a denial of the request, then the extension is automatically granted.⁶ There is no counterpart to this notion in the common law. It is important for the international lawyer to understand these principles when drafting a contract.

Some contract codes, like the CISG, can be used to create a checklist of issues or clauses that should be dealt with in an international contract. Figure 11.3 *Focus on Transactions*: "Checklist of Important International Contract Clauses" provides an example of a checklist prepared by the **International Chamber of Commerce (ICC)**, illustrating how a substantive body of law or principles may be utilized as a checklist in the drafting of a contract.⁷ This checklist lists issues covered in the **UNIDROIT Principles of International Commercial Contracts (PICC)**. The material in parentheses refers to the relevant articles of the *UNIDROIT Principles*.

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| <ul style="list-style-type: none"> • Exclusion of trade usage (Articles 1.8, 4.3(f)) • Four corners clause (integration or merger clause) (Articles 2.17 and 2.18) • Time of performance, early performance, late performance (Articles 6.1.1, 6.1.5, and 7.1.5) • Order of performance (Article 6.1.4) • Place of performance, place of payment (Article 6.1.6) • Form of payment (Articles 6.1.7 and 6.1.8) • Currency of payment (Article 6.1.9) • Transportation costs, other expenses (Article 6.1.11) | <ul style="list-style-type: none"> • Government approvals (Articles 6.1.13–6.1.17) • Hardship clause (Articles 6.2.1–6.2.3) • <i>Force majeure</i> clause (Article 7.1.7) • Termination clause, notice provisions (Articles 7.3.1 and 7.3.2) • Forum selection and arbitration clauses (Article 7.3.5(3)) • Limitation of liability clause (Article 7.1.6) • Interest on delinquent payments (Article 7.4.9) • Damages, liquidated damages clause (Articles 7.4.1–7.4.4 and 7.4.13) |
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Figure 11.3 *Focus on Transactions*: Checklist of Important International Contract Clauses.

Principles of international contracting are important for reasons other than drafting and performing contracts. Foreign courts and arbitration panels will use these principles when interpreting an ambiguity in a contract. The next section examines the process of contract interpretation that is pivotal to the resolution of contract disputes.

Contract Interpretation

An important part of contract law pertains to the rules or standards used by courts in the interpretation of contracts. In U.S. contract law, the standard of review is embedded in the reasonable person approach. In the United States, the *imprimatur* of the reasonable person approach can be seen throughout the **Restatement (Second) of Contracts** and the **UCC**. It can be seen whenever reference is made to the fact that a party had reason to know or should have known something. There is *reason to know* if a person “has information from which a person of similar intelligence would infer that the fact in question does or will exist.” The line between *reason to know* and actual knowledge is often nonexistent. *Reason to know* is a factual determination based upon the circumstances and information available to the parties. In contrast, *should know* is generally associated with a legal duty to know. “Should know imports a duty to ascertain the facts.”⁸ Thus, *should know* is relatively unconcerned with actual knowledge.

The determination of whether a party had *reason to know* is accomplished through the **totality of the circumstances analysis**.⁹ This analysis takes into account all the circumstances of the contract, including the contract itself, prior dealings between the parties, how the parties performed the contract, subsequent modification to the contract, and relevant business customs and trade usage. *Should know* is more a judicial reflection regarding what is reasonable given the parties and the circumstances. The difference is that *reason to know* is more a party-specific analysis. In contrast, *should know* is community focused, that is, it determines what is a reasonable interpretation or result based on business or community standards.¹⁰ For example, “what is reasonable depends on the circumstances; it may be reasonable to hold a nonmerchant to mercantile standards if he is represented by a mercantile agent.”

Modern contract law has witnessed an increasing preemption by statutory law of interpretation analysis. The **English Unfair Contract Terms Act of 1977** adopts a presumption of unreasonableness for indemnity or exculpatory clauses that “by reference to any contract term a party is made to indemnify another party in respect of liability for negligence or breach of contract.”¹¹ For international sales contracts it voids any choice of law clause whose purpose is the avoidance of the Unfair Contract Terms Act. This statute is an example of how mandatory rules preempt a court’s search for the contractual intent of the parties. The intent of the parties regarding such a clause becomes irrelevant because the statute invalidates it.

Customary law, by way of examining current custom and trade usage, has often been the vehicle by which the common law has fabricated the reasonable person in interpreting contracts. Justice Turley in the 1842 case

Jacob v. State convincingly states this grassroots metamorphosis. “Common law sources are to be found in the usage, habits, manners, and customs of a people. The common law of a country will be modified, and extended by analogy, *construction*, and *custom*, so as to embrace new relations, springing up from time to time, from an amelioration or change of society.”¹² The courts use the reasonable person standard to discourage unconscionable practices and encourage the development of judicially approved standards of reasonableness.

Convergence and Divergence of National Laws

The interrelationship between national and international legal systems is critical to the entrepreneur and the legal practitioner in assessing the legal risks of a transaction. One commentator states that “with the world so interrelated, economic relations and their international aspects are influenced by the interests of and relations between subjects of commercial law from various countries.” Even without the development of uniform international laws like the CISG, there has been a significant convergence of contract law between different legal systems.

Liquidated Damages and Penalty Clauses

Liquidated damages clauses state in advance the damages that the parties agree to voluntarily pay upon breaching the contract, technically eliminating the need for a court action or arbitral proceeding. These clauses, however, also known as penalty clauses, are not uniformly enforced under all national legal systems. This section will compare substantive differences in liquidated damages law among different legal systems. The common law system requires courts to void liquidated damages clauses that act as penalties. A penalty is an inflated amount aimed at punishing the breaching party. This voiding of penalties is a minority approach under most national laws. The French Civil Code deals directly with the issue of liquidated damages or penalty clauses: Article 1152 allows the courts to provide alternative relief if the stipulated amount is “manifestly excessive.” It expressly grants courts the authority to reduce or increase the penalty if it is deemed to be manifestly excessive or low. In Japan, there is a strong presumption that penalty clauses are enforceable. Article 420(3) of the Japanese Civil Code states that: “a penalty clause is presumed to be a determination in advance of the amount of compensation due for damages.” Article 420(1) of the Japanese Civil Code precludes a court from reforming (adjusting) the contract amount.

The laws of Denmark, Sweden, Finland, and Norway allow either the voiding or reformation of a penalty clause deemed unreasonable. The Russian Civil Code provides that “the debtor must pay the penalty established for the breach regardless of whether or not the creditor has suffered damages as a result of the breach” and, in Article 190, allows a court to reduce the amount of the penalty or liquidated damages if it is “extraordinarily large in comparison with the creditor’s actual losses.” In contrast, Anglo-American common law simply mandates the voiding of all penalty clauses.

In order to provide some uniformity between common law and civil law, the Council of Europe adopted *Resolution (78)3 on Penal Clauses in Civil Law*. It adopts the civil law approach that the “sum stipulated may be reduced by the court when it is manifestly excessive.” In its Explanatory Memorandum, the Committee on Legal Cooperation explained that some penal clauses are “*stricto sensu* whose main purpose is to act as a threat to induce the promisor to perform” while others are “a genuine pre-assessment of damages or liquidated damages.” However, unlike in the common law, the clauses that are *stricto sensu* are not invalid *per se* under the civil law. In short, it is acceptable under the civil law for a liquidated damages clause to serve as not only a means for just compensation, but also an incentive to induce performance.

See Figure 11.4 *Comparative Law: “Penalty Clauses in Europe and the United States,”* which features an analysis of a resolution of the **Council of Europe** pertaining to the enforceability of **penal clauses** or what U.S. legal practitioners call the liquidated damage clause. Compare Resolution 78(3) with the excerpts that follow from the American UCC and the Restatement (Second) of Contracts for differences in approaches to the issue of penalty (liquidated damages) clauses.

Council of Europe Resolution (78) 3 (On Penal Clauses in Civil Law)

Considering that the aim of the Council of Europe is to achieve greater unity between its members, in particular the adoption of common rules in the field of law, and considering that it is necessary to provide judicial control over penal clauses in civil law in appropriate cases where the penalty is manifestly excessive.

Article 2

The promisee may not obtain concurrently performance of the principal obligation, as specified in the contract, and payment of the sum stipulated in the penal clause unless the sum was stipulated for delayed performance.

Article 7

The court may reduce the sum stipulated when it is determined to be manifestly excessive.

Explanatory Memorandum

The legal systems of member states have devised various means to enable courts to exercise a certain control over penal clauses, although the circumstances under which this control can be exercised differ considerably from one state to another. It is one of the essential aims of the present resolution to contribute towards a *harmonisation* of the laws of the member states.

It is left to each legal system to determine under what precise circumstances the sum concerned is manifestly excessive. It is suggested that in a given case the courts may have regard to a number of factors such as:

- i Comparing the damage pre-estimated by the parties at the time of contracting and the damage actually suffered by the promisee.

- ii The legitimate interests of the parties including the promisee's non-pecuniary interests.
- iii The category of contract and the circumstances under which it was concluded, in particular the relative social and economic position of the parties, or the fact that the contract was a standard form contract.
- iv The reason for the failure to perform, in particular the good or bad faith of the promisor.

Law of Liquidated Damages in the United States**UCC Section 2-718: Liquidation or Limitation of Damages**

Damages for breach may be liquidated in the agreement but only at an amount, which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience of obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

Restatement (Second) of Contracts Section 356, Comment b.

Factor 1: The amount fixed is reasonable to the extent that it approximates the actual loss caused by the breach. Furthermore, the amount affixed is reasonable to the extent that it approximates the loss anticipated at the time of the making of the contract.

Factor 2: If the difficulty of proof is great, considerable latitude is allowed in the approximation of anticipated or actual harm.

Figure 11.4 Comparative Law: Penalty Clauses in Europe and the United States.

It should be noted that a businessperson from a common law country should be aware that penalties are enforced in most countries and are recognized by international arbitrators.

Doctrine of Arrhes

A further review of foreign national laws demonstrates that the common law approach to liquidated damages is not the only viable alternative. For example, the French Civil Code allows for the use of deposits as a way of fixing damages unrelated to actual damages. This concept of deposit forfeiture mimics the doctrine of *arrhes* is found in Section 1590 of the French Civil Code. Under the doctrine of *arrhes*, a deposit is forfeited when the deposit giver cancels a contract. If the deposit holder cancels the contract, then that party must refund twice the amount of the deposit. The rules embodied in the doctrine of *arrhes* can be understood as the use of deposits as liquidated damages. Furthermore, the potentially penal nature of retaining the entire deposit or doubling the amount refunded is disregarded under this doctrine.

Despite the growing similarities among the different legal systems, significant divergence remains. There are concepts within the civil law systems simply not found in common law. A review of the provisions below taken from the **French Civil Code** demonstrates that there are foreign contract law principles that have no American law counterpart.

French Civil Code Section 1590

If the promise to sell was made with payment of a deposit (arrhes), each of the contracting parties is at liberty to withdraw. The one who paid the deposit, on forfeiting it, and the one who received it, on returning double the amount.

Section 1587

With regard to wine, oil, and other things, which it is customary to taste before buying, there is no sale so long as the buyer has not tasted and approved them.

Sections 1674, 1681, and 1706

If the price of an immovable is inadequate by less than seven-fifth of its true value, the seller has the right to demand rescission of the sale, even though he has expressly renounced in the contract the option to demand rescission. In case the action for rescission is upheld, the purchaser has the option either to return the thing upon recovering the price which he has paid, or to keep the property upon paying the balance of the just price, after deducting one-tenth of the total price. No rescission for inadequacy may take place in a barter contract.

Note the differences between the **doctrine of arrhes**, as described in Section 1590 of the French Civil Code, and the normal deposit given in U.S. business transactions. Does the doctrine of *arrhes* invite either party to breach the contract if they change their minds? Can the doctrine of *arrhes* be used as an implicit liquidated damages or penalty clause? Why are the inspection rights for wine and other similar products so different than what is found in most sales of goods transactions? Why do you think the just price provision allows the buyer to retain 10 percent of the value of the goods?

Execution in Counterpart: Some countries do not recognize the ability of the parties to sign two different copies of their agreement—one signs one copy and the other signs another copy; they then exchange the forms, but no one form has both signatures—as adequate to form a contract. In the sale of goods there is often an exchange of forms with only one signature on each, but they are different forms, such as a price quotation (seller), purchasing order (buyer), or a confirmation (seller or buyer). This exchange of forms is considered sufficient to form a sale of goods contract.

Collateral Obligations

It is important to realize that national differences in the requirements of and restrictions on contracting are often found throughout a country's regulatory network. These noncontract law regulations impact directly on contract issues. For example, Article 433 of the **German Civil Code** indicates that a producer or supplier of goods in an ongoing relationship, such as a distribution agreement, has a "*collateral obligation* to have replacement parts ready for delivery even if there is no special agreement." In contrast, in the U.S., issues of after-sales service and replacement parts supply are left to the private agreement of the contracting parties.

Law in Action

Another area of concern for the international entrepreneur is the difference between "law in books" and "law in action." A number of countries have enacted modern Westernized commercial codes, but uniformity in their interpretation and application is somewhat lacking. An example is the law of many Islamic countries where there is a direct interrelationship between religious and secular codes. The main body of law, the **Shari'a** law comprises religious, social, and legal mandates. The main body of this source of law was completed by the early tenth century, at least as practiced by the majority Sunni sect. Beginning with the Ottoman Empire in the nineteenth century,

however, “the *Shari’a* lost its exclusivity as the governing law of contracts to a combination of sacred and secular laws.”¹³

The secular laws have included a modern codification of contract and commercial law with which a Western businessperson would be quite comfortable. For example, Saudi Arabia has enacted a set of regulations, including ones governing commercial law, negotiable instruments, and corporate law. The problem for an outside businessperson is that the principles of the *Shari’a* still take precedence over these secular statutes. Most of the judges in the secular court system have religious training, and their decisions are reviewed by a Commercial Board to ensure conformity with the dictates of *Shari’a* law. The application and intrusion of religious principles into commercial law disputes is sporadic, but it is important to note that a party may seek to overcome a decision based on the commercial codes by resorting to *Shari’a* principles.

National Contract Laws

A person attempting to do business in a foreign country should make a good faith effort to acquaint herself with that country’s contract and sales laws. A thorough examination is not possible here, but the existence of statutory or commercial codes will allow a cursory review. Even a cursory review will highlight some of the similarities and differences between home and host country laws. I have selected the **Russian Civil Code**, the **Chinese Contract Law (CCL)**, and the **Principles of European Contract Law (PECL)** for review. The first two are examples of transitional economies enacting Western-style codes compatible with an emerging market economy. The latter example more closely resembles a “restatement” of general principles taken from the underlying national contract law systems.

Russian Civil Code

The Russian Civil Code is reviewed as an example of a civil law system. The enormous change in the legal systems of the Soviet-bloc countries included the adoption Western European-style Civil Law Codes. A brief look at selected provisions of the Russian Civil Code will illustrate some of the similarities and differences between this first generation commercial statute and U.S. contract law. Chapter 18’s coverage of intellectual property law will illustrate not only some of the substantive differences but also the problems with the legal enforcement of these new laws.

Formalities and Writing Requirements

The most obvious observation in reviewing the contract provisions of the Russian Civil Code is how similar the rules are to our common law. The Code displays many of the principles and concepts found in U.S. contract law. Article 158 allows silence as a means of acceptance only if there was a prior agreement of the parties. Article 160 defines the requirements of the written form, or what is under U.S. law known as the **statute of frauds**, more broadly and is more modern than the definition currently found in Article 2 of the UCC. For example, Paragraph 2 of Article 160 states: “the use when concluding a transaction of a facsimile reproduction of a signature with the assistance of mechanical or other means of copying, electronic-cypher signature, or other analogue of a signature in one’s own hand shall be permitted in the instances and procedure provided by a law, other legal acts, or by agreement of the parties.” Section 162 expressly notes that foreign economic transactions are invalid unless in writing. Although oral contracts are recognized in some instances, the Russian Civil Code places strong emphasis on formalities including the written form, notarial certifications, and in some cases, governmental registration. As a general rule, a foreign party should not contemplate moving forward on a business transaction without a formal written contract. It is also good practice, even if not technically required in a given transaction, for the parties’ signatures to be notarized.

Contract of Adhesion and Unfair Contracts

Section 428 recognizes the U.S. notion of the **contract of adhesion** where a party signs the contract form provided by the other party on a take-it-or-leave-it basis. It grants to the contract form receiving party a right to demand

dissolution. Thus, a term that is not contrary to the law may be voided if it deprives the adhering party of the rights “usually granted under contracts of that type, or excludes or limits the responsibility of the other party.” The importance of disclosure as a means to preclude the right to demand dissolution is also recognized. The adhering party cannot demand dissolution if he “knew or should have known on what conditions the contract is concluded.” This general mandate against the enforcement of unfair terms in an adhesion contract can be contrasted with the **European Union Directive on Unfair Terms** in consumer contracts. That directive is much narrower in scope in that it invalidates only certain types of exculpatory clauses. An exculpatory clause generally insulates one of the parties from liability due to its own negligent acts.

Despite the overall similarities between the Russian Civil Code and U.S. contract law, there are some unique provisions in the Russian Code foreign businesspersons should become familiar with. An example can be found in the types of contracts that need to be in written form. Contracts of a certain amount need to be in writing. Article 162 expressly states that in an international business transaction “the failure to comply with the simple written form of a foreign economic transaction shall entail the invalidity of the transaction.” Furthermore, some types of contracts require a notary’s certification and some international contracts need to be registered with government agencies. Failure to do so also results in the contract being invalidated. If the contract is executory or yet to be performed, then failure to register renders it null and void. However, in a partially performed or concluded contract the court has the option of enforcing the contract by ordering the parties to register the contract.

Of critical importance to the foreign contracting party are the provisions dealing with preliminary contracts and precontractual liability, changes of circumstances, and quality of goods. See Figure 11.5 *Doing Business Internationally*: “Questions and Answers: Provisions of the Russian Civil Code.”

Preliminary Contracts

- 1 Does Russian contract law recognize the enforceability of “preliminary contracts?” Yes,
Article 429: Preliminary Contract states that in entering a preliminary contract the parties shall be obliged in a future contract to include the conditions provided for by the preliminary contract.
- 2 How is a preliminary contract formed? It must be formed in the same way as the principal or actual contract is to be formed and if the form of the principal (final) contract has not been established, then in *written form*.
- 3 What must a preliminary contract contain to be enforceable? It must contain a description of the subject matter of the contract and the other material conditions of the principal contract.
- 4 For how long a period of time is a preliminary contract enforceable? How long a period of time does the parties have to conclude the principal contract? A preliminary contract shall specify the period in which the parties are obliged to conclude the principal contract. If such period is not provided in the preliminary contract, the principal contract shall be subject to conclusion within a *year* from the moment of concluding the preliminary contract.

Change of Circumstances

- 1 The law allows the termination of the contract if there has been a material change of circumstances subsequent to the formation of the contract. What is considered to be a material change of circumstances? Article 451 states that a change of circumstances is material when “they have changed such that if the parties could reasonably foresee this, the contract would not have been concluded at all by

them or it would have been concluded on significantly differing conditions.”

- 2 When will a party have the right to terminate the contract? A request to terminate will be considered by a court when the following conditions are present: (a) At the moment of concluding the contract the parties proceeded from the fact that such a change of circumstances would not occur; (b) The change of circumstances has been caused by reasons which the interested party could not overcome after they arose with that degree of concern and care which are required of him by the character of the contract and the conditions of turnover; and (c) The performance of the contract without a change of its conditions would so violate the correlation of property interests of the parties which correspond to the contract and entail for the interested party such damage it would be deprived to a significant degree of that which it had the right to count on when concluding the contract; and (d) It does not arise from the customs of business turnover or the essence of the contract that the risk of the change of circumstances is borne by the interested party.
- 3 If the termination is granted, do the parties have any further obligations to each other? Yes, the court at the demand of any of the parties shall determine the consequences of the dissolution of the contract by proceeding from the need for a *just distribution* between the parties of the expenses incurred by them in connection with the performance of the contract.
- 4 Does the court, upon a finding of a material change of circumstances, have any other remedy other than the termination of the contract? Yes, it may elect to change the contract terms in place of terminating the contract, but only when the termination of the contract is “contrary to social interests or entails damage for the parties, which

significantly exceeds the expenditures needed to perform the contract on the conditions changed by the court.”

Quality of Good (Articles 469 and 475)

- 1 What qualifies as conforming goods or goods of sufficient quality if the contract does not provide a specific warranty? The goods must be of the quality that “corresponds to the contract of sale.” The contract will almost always contain a description of the goods being sold; therefore, the goods are of sufficient quality if they conform to that description.
- 2 How in the absence of a written contract or where a written contract is vague about the standard of quality is sufficient quality to be determined? The seller shall be obliged to transfer goods “fit for the purposes for which a good of such nature is usually used.” If the seller when concluding the contract was given notice by the purchaser of the specific purposes for purchasing the goods, then “the seller shall be obliged to transfer to the purchaser a good fit for use in accordance with these purposes.”
- 3 What if the warranty of the contract is based upon a sample provided by the seller or a model provided by the buyer? The sample or model is the warranty, that is, the goods supplied must be of equal quality to the sample and identical to the model or prototype.
- 4 What are the purchaser’s options or remedies for delivery of nonconforming (defective) goods? The purchaser shall have the right to require from the seller: (a) commensurate reduction of the purchase price; (b) elimination without compensation of the defects of the good within a reasonable period; and (c) compensation of his expenses to eliminate the defects of the good.

Comparative Highlights

- There is no counterpart in American contract law (Uniform Commercial Code or UCC and the common law) to Article 429 of the Russian Code on Preliminary Contracts. Technically, there can be no such thing as a preliminary contract in the common law. The common law requires

that in order for a contract to be formed (or what Europeans call a conclusion of contract), there must be evidence of a general intent of the parties to enter a binding contract and an agreement on all material terms. If a preliminary contract leaves some of the material terms for future negotiations, then it cannot be an enforceable contract. In recent cases in the U.S., some courts have found preliminary agreements, such as an “Agreement to Agree,” to be binding contracts. In such cases, the preliminary contract is limited in scope. It does not require the parties to enter into a final contract; it simply requires them to negotiate in good faith, whether or not that leads to a final contract.

- In the area of change of circumstances, Article 451 is a common approach in the Germanic family of the civil law. It provides an excuse out of a contract and an exemption of liability from breaching of the contract when the contract breach is due to a change of circumstances. The difference between the Russian Civil Code and the common law is how they define a *material* change of circumstances. In the common law, the material change needs to make it impossible (natural disaster, port strike, government intervention) for one of the parties to perform or the purpose of the contract has been frustrated. The Russian Civil Code follows German contract law, which allows the termination of the contract when the change of circumstances results in a mere hardship on one of the parties (more costly to perform or less profitable). The common law does not provide an excuse for mere hardship. However, the UCC adopted the doctrine of impracticability, which seems to be very much like the hardship excuse. In practice, the courts infrequently apply the doctrine.
- The standards for quality of goods in Articles 469 and 475, what is called warranty law in American law, is very similar to the American UCC. Descriptions, samples, and models are considered to be express warranties; the Russian Code’s requirement that goods must be “fit for the purposes for which a good of such nature is usually used” is equivalent to UCC Section 2-314 (**implied warranty of merchantability**); the need for the goods to be “fit for use in accordance with the purposes of the purchaser” is equivalent to UCC Section 2-315 (**implied warranty for a particular purpose**).

Figure 11.5 *Doing Business Internationally*: Questions and Answers: Provisions of the Russian Civil Code.

Preliminary Contracts, Change of Circumstances, and Implied Warranties

Article 429 recognizes the preliminary contract, which is not recognized under U.S. law. The parties have an affirmative obligation to conclude the contract under the Russian notion of preliminary contract. If the parties fail to state a time for concluding the contract, then the law provides that it should be concluded within one year from the conclusion of the preliminary contract. Thus, the potential for precontractual liability is much greater under the Russian Civil Code than under U.S. law. Of course, “preliminary contract” can be a misnomer if the preliminary is considered as a contract unto itself.

Article 451 recognizes an excuse (exemption from liability for breaching a contract) for a “material change of circumstances.” Paragraph 2 lists four conditions similar to those found in U.S. excuse doctrines: (1) the contract was premised on the change of circumstances not occurring, (2) the party could not avoid the

occurrence even when using reasonable care, (3) the occurrence materially alters the contract, and (4) it was not an allocated risk under the contract or through industry custom. The subject of excuse will be studied more fully in Chapter 12.

The final topic to be examined is the recognition of implied warranties. Paragraph 2 of Section 469 of the Code offers a broader selection of remedies to the injured party than what is found in the American UCC. Under the UCC, the buyer must pay in full and then make a claim for damages under a breach of warranty claim. In contrast, the price reduction remedy allows the buyer to unilaterally reduce the price based on the diminishment of value caused by the defect. Also, the Russian Civil Code allows the buyer the option to demand specific performance by requiring “the replacement of the good of improper quality by a good corresponding to the contract.”

Chinese Contract Law

Another interesting codification of contract law, aimed at facilitating international trade, is the **Chinese Contract Law (CCL)** of 1999. Before adoption of the CCL, China had a domestic contract law and a foreign contract law, which applied when one of the parties was non-Chinese. This later law was entitled: Law of the People’s Republic of China on Economic Contracts Involving Foreign Parties (Foreign Economic Contracts Law). However, the Foreign Economic Contract Law was repealed upon the adoption of the CCL, giving China a unified contract law for both domestic and international transactions. The CCL is a more modern and comprehensive law than the previous contract law. This was mostly because the drafters of the CCL borrowed extensively from the CISG (which had already been enacted by China as its international sales law) and the UNIDROIT PICC.

Structure of CCL

The CCL is made of two parts—the first part provides the general law of contracts and the second provides specialized rules for specific types of contracts. The general law of contract (General Provisions) is divided into eight chapters: Chapter 1 deals with general provisions; Chapter 2 with contract formation; Chapter 3 with contract validity; Chapter 4 with performance of contracts; Chapter 5 with modification and assignment; Chapter 6 with discharge of contracts (termination); Chapter 7 with liabilities for breach of contract; and Chapter 8 with miscellaneous provisions, including a statute of limitations. The second part (Special Provisions) is divided into the following types of contracts: (1) Sales Contracts; Contracts for Supply of Power; (2) Water, Gas, or Heat; (3) Gift Contracts; (4) Lending Contracts; (5) Leasing Contracts; (6) Financial Leasing Contracts; (7) Contracts of Hired Works; (8) Contracts for Construction Projects; (9) Carriage Contracts; (10) Technology Contracts; (11) Safekeeping Contracts; (12) Warehousing Contracts; (13) Agency Contracts; and (14) Brokerage Contracts.

General Principles

The CCL is very much a Western-style law that is mostly aligned with the civil law tradition, but also has a great deal of similarities to the common law tradition. The most obvious difference is seen in its general principles where remnants of the former socialist system persist. It accepts the core principle of freedom of contract that the parties may make any agreement that does not violate the law. However, the other general principles place limits on such freedom:

- Article 3: Contract parties enjoy equal legal standing and neither party may impose its will on the other party.
- Article 5: The parties shall abide by the principle of fairness in prescribing their respective rights and obligations.
- Article 6: The parties shall abide by the principle of good faith in exercising their rights and performing their obligations.

Article 3 implies that the parties are free to make any type of agreement (“equal legal standing”); but also, it recognizes that a party with superior bargaining power can abuse its freedom of contract (“neither party may impose its will on the other party”). The CCL states that “parties should take each other’s reasonable interests into account” when performing the contract. The principle of fairness in Article 5 has no counterpart in the common law. U.S. law has the doctrine of unconscionability, which allows a court to void a contract that is extremely one-sided and was a product of unfair bargaining.

The duty of good faith in the performance of contract (Article 6) is found in American contract law, but has been rejected in English law. However, the CCL adopts the version of good faith found in German law. German law is dominated by the good faith principle, which influences all areas of contracts, such as precontract negotiations, performance, and contract interpretation. Unlike the common law, the CCL obligates parties to negotiate in good faith. If a party negotiates in bad faith, then that party may be liable for damages even though a contract had not been formed. The CCL provides that a party is not acting in good faith if she: (1) entered into negotiations with no real intention of reaching an agreement; (2) takes unfair advantage of the other party’s dependence, economic distress, or weakness; and (3) negotiates an unconscionable bargain. Elsewhere in the CCL the good faith principle is found in specific rules. For example, inconsistent behavior in performing the contract violates the principle: “Good faith prevents a party from adopting an inconsistent position when the other party has reasonably acted in reliance on the former’s statement or conduct.”

In the negotiation of a contract, Article 42 states that a party is liable for damages under the following situations: (1) negotiating in bad faith under the pretext of concluding a contract; (2) intentionally concealing a material fact relating to the negotiation of the contract or supplying false information; and (3) any other conduct which violates the principle of good faith. The remedy is for “retroactive damages,” what in the common law is referred to as reliance damages, which include “expenses incurred; the work done; losses on transactions entered into in reliance of the expected contract; and arguably loss of opportunities.” Article 60 states that the parties shall observe the principle of good faith and perform such duties as giving notice, providing assistance, and maintaining confidentiality in accordance with the nature and purpose of the contract as well as the usage of the transaction.

Contract Formation

In the area of contract formation, the CCL adopts the standard model of offer–acceptance. Its rules are closely aligned with those found in the common and civil laws. In comparing the CCL to U.S. law (common law), the CCL adopts the civil law approach to the time of contract formation. In the common law, a contract is formed when the acceptance is dispatched (“**mailbox rule**”), while under the CCL and the civil law, as well as the CISG, a contract is not formed until the acceptance is received. This is important since under the dispatch rule the contract is formed at an earlier time and the risk of loss is shifted to the receiving party. The civil law’s receipt rule is the superior rule because it places the risk of loss in the transmission of the acceptance on the sending party (“most efficient insurer”).

The CCL also indicates that the written contract should display a high degree of certainty of terms. Article 12 states that contracts should contain the following provisions:

- title, name, nationality, and place of business of the parties;
- date and place of its signing;
- contract type, along with the category and scope of contractual objectives;
- objectives regarding technology terms, quality, standard, specifications, and quantity;
- time limit on, place of, and method of performance;
- conditions on price, amount, and method of payment;
- terms and conditions for assignment;
- compensation and liabilities for breach;
- methods of settlement;
- language of the contract.

Anticipatory Repudiation (Breach)

The CCL also adopts the concept of anticipatory repudiation (breach), which allows a party to anticipate a future breach in order to immediately terminate the contract and sue for damages. Article 68 states:

The party who is to perform the obligation first may suspend his performance if he has definite evidence to prove that the other party has one of the following circumstances:

- 1 *His business operation has significantly deteriorated;*
- 2 *He has removed assets or surreptitiously withdrawn funds in order to evade his obligations;*
- 3 *He has lost his commercial goodwill;*
- 4 *Other circumstances indicate that he has lost or may lose the ability to perform his obligation.*

If a party suspends his performance without definite evidence, he shall be liable for breach of contract.

Initially, the party declaring an anticipatory repudiation may only suspend the contract and not terminate the contract pending the other party's response. He first must give the other party a notice of repudiation in a timely manner. Article 69 allows the other party to provide evidence (assurance) that it will perform on time. Performance shall be resumed if the other party provides "appropriate security." In such a case, the suspension would be released and the contract reinstated.

Liquidated Damages and Deposits

Article 114 recognizes the enforceability of liquidated damages (pre-agreed damages inserted in the contract): "The parties may agree that a party, when breaching the contract, shall pay a certain amount of liquidated damages to the other party according to the circumstances of the breach, and they may also stipulate the method for calculating the amount of damages arising from the breach. If the agreed liquidated damages are lower than the loss incurred, the parties may apply to the people's court or arbitral institution for an increase; if the agreed liquidated damages are *excessively higher* than the loss incurred, the parties may apply to the people's court or arbitral institution for an appropriate reduction." Despite using the common law term of liquidated damages, Article 114 actually adopts the civil law rule that penalties (an amount above actual damages) because of its use of the phrase "excessively higher." The civil law enforces penalty clauses unless the stipulated damages in the clause are manifestly excessive. The common law rejects the enforceability of all penalty clauses.¹⁴

Interestingly, the CCL also adopts the "deposit rule" found in the French doctrine of *arrhes*. Article 115 of the CCL recognizes a party's option to deliver a deposit as security relating to a contract. As with the doctrine of *arrhes*, if the party that gives the deposit fails to perform, the party holding the deposit is allowed to keep it. If the party holding the deposit fails to perform, then "he shall return double the amount of the deposit." However, in the case where the contract provides for a deposit and liquidated damages, Article 116 states that "where the parties have stipulated both liquidated damages and deposit and a party breaches the contract, the other party may choose to apply the liquidated damages clause or the deposit clause," but not both.

Article 113 adopts the Anglo-American *Hadley v. Baxendale*¹⁵ limitation on damages. Under the rules of *Hadley*, damages are not to exceed those that could have been foreseen at the time of contract formation by the party breaching the contract. Therefore, the breaching party is liable only for foreseeable damages and not the actual damages caused by its breach. Article 119 adopts the common law principle of mitigation. The nonbreaching party "should take appropriate measures in a timely manner to prevent the increase of losses."

Force Majeure

Articles 117 and 118 recognize the excuse of *force majeure* ("superior force"). A *force majeure* event is some unforeseeable event that prevents one party from performing on the contract. The law will generally excuse the

nonperforming party from the contract without liability. The requirements for a *force majeure* event are outlined in Article 117. Such events “shall mean events that are *unforeseeable*” at the time of contracting and whose “occurrence is *unavoidable* and cannot be overcome by the parties.” The breaching party is required by Article 118 to notify the other party in a timely manner.

Standard Terms

The CCL also regulates **standard terms**. Standard terms are defined as “terms which are formulated in advance for repeated use by a party and which are not negotiated with the other party when concluding the contract.” Article 39 provides the party supplying standard terms “shall comply with the principle of fairness when determining the rights and duties of the parties, shall, in a reasonable manner, draw the attention of the other party to the terms which exclude or limit his liability, and shall, upon the other party’s request, explain such terms.” Thus, standard terms that are overly one-sided or would “surprise” the other party if he knew of their existence and meaning are unenforceable. The CCL expressly voids exemption (disclaimer) clauses that limit a party’s liability for personal injury or liability for property loss caused by the party acting either intentionally or as a result of gross negligence.

Sales Contracts

The CCL’s part on sale of goods has a number of rules that are worth noting. Article 137 recognizes the uniqueness of computer software sales. In the sale of computer software, “intellectual property rights in the subject matter do not vest in the buyer, unless the law provides or the parties agree otherwise.” This recognizes that the sale of software includes a license to use the software, but ownership in the intellectual property remains with the seller (“licensor”).

Article 156 requires the seller of goods to properly package the goods for shipment. If there is no agreement on the manner of packaging or if the agreement is unclear, the customary manner of packaging shall be applied; if there is no such customary manner (trade usage), the manner of packaging that is adequate to protect the subject matter shall be adopted. An important issue in sale of goods involves long-term supply contracts. The key issue being if a party fails to deliver an installment or make a payment, or the seller delivers an installment of defective goods, does the nonbreaching party have the right to terminate the entire contract (including future installments)? Article 166 deals with this issue by providing the following rules: (1) if the seller fails to deliver one of the installments or delivers defective goods, the buyer may terminate the contract in respect of that one installment; (2) if the seller fails to deliver one of the installments or fails to deliver it in conformity with the agreement, thereby making it impossible for all the future installments to accomplish the purpose of the contract, the buyer may terminate the contract in respect of that installment and all the future installments; and (3) where the buyer terminates the contract in respect of one of the installments, if that installment and other installments are interdependent, he may terminate the contract in respect of all the delivered and undelivered installments.

Principles of European Contract Law

In 1998, the European Union’s Commission on Contract published its revised **Principles of European Contract Law (PECL)**. The stated purpose of the PECL was to respond to a need for a Community-wide infrastructure of contract law to consolidate the rapidly expanding volume of Community law regulating specific types of contracts. Article 1.101 states that the PECL will apply to contract disputes in two main scenarios: when the parties select them as their choice of law and when the contract is to be governed by general principles of law or the *lex mercatoria*. The former scenario is likely to occur when the contracting parties are in disagreement over the application of a given national law. The PECL, like the CISG, serve as a broad, fairly written compromise choice of law. The CISG is a better choice in a sale of goods transaction, while the PECL apply to all types of

contracts. The second scenario is likely to occur in the setting of international arbitration. Arbitrators, at times, want to avoid the application of an idiosyncratic rule of national law in favor of a “fairer” general principle found in international customary law. In time, arbitrators may recognize the PECL as evidence of customary international law.

A review of the PECL demonstrates a large amount of similarity with the U.S. common law of contracts and the UCC. It also shows significant differences that could potentially lead to unexpected liabilities for one who is familiar only with U.S. law. The following review outlines some of the differences and notes comparable provisions in the CISG. One caveat should be noted: The U.S. businessperson will find a great deal more of common ground than differences when comparing the PECL with U.S. contract law. It is important, however, to understand the differences in order to avoid certain liabilities. For example, the PECL adopts the CISG’s approach to formalities. Article 2.101 is almost identical to Article 11 of the CISG: “A contract need not be concluded or evidenced in writing nor is it subject to any other requirement as to form. The contract may be proved by any means, including witnesses.”

The PECL goes farther than even the CISG in rejecting provisions that reduce the admissibility of evidence in a contract dispute. The enforceability of common contract clauses, such as written modification and merger clauses, is jeopardized under Articles 2.105 and 2.106. Under these articles, a **written modification clause** that requires a writing to make any changes to the contract provides only a presumption. The other party may still introduce evidence in order to rebut the presumption. The articles further state that: “a party may by its statements or conduct be precluded from asserting such a clause.” Article 4.110 makes an exception for terms that provide the “main subject matter of the contract” and are provided in “plain and intelligible language.” Also, the adequacy of value exchanged between the parties is not a ground for voiding a term.¹⁶

In addition, a **merger clause** (purpose of the merger clause is to prevent the use of extrinsic evidence to contradict a term in the contract) found in a standard form or in the general conditions section of a contract does not fare very well under the PECL. The following definition of general conditions is provided in Article 2.209(3): “General conditions of contract are terms which have been formulated in advance for an indefinite number of contracts of a certain nature, and which have not been individually negotiated between the parties.” The standard merger clause states that the document into which it is incorporated is a final integration of the parties’ agreement and supersedes all other statements, writings, or correspondences. A merger clause that is *individually negotiated* will be enforced, otherwise the clause establishes only a presumption. However, even when fully negotiated a merger clause can be voided in the case of ambiguity in the contract or on grounds of waiver. Article 2.105 states that “the parties’ prior statements may be used to interpret the contract.” Regarding subsequent statements and conduct, it provides that such statements and conduct may preclude a party “from asserting a merger clause to the extent that the other party has reasonably relied upon the subsequent statements or conduct.”

In the area of **notice**, the PECL states that notice becomes effective “when it reaches the addressee.” The PECL qualifies this rule by stating that a properly dispatched notice of nonperformance, which is subsequently lost or delayed in transmission, “shall have effect from the time at which it would have arrived under normal circumstances.” Notice plays a much larger role in the actual negotiation of contract terms under the PECL than it does under the common law system. Article 2.104 states that “contract terms which have not been individually negotiated may be invoked against a party who did not know of them only if the party invoking them took reasonable steps to bring them to the other party’s attention before or when the contract is concluded.” Note that the individual negotiation rule is not confined to standard form contracting or merchant-to-consumer transactions (consumer contract). Article 4.110 allows a party to void an unfair term that was not individually negotiated. It defines “unfair” as a term that “causes a significant imbalance in the parties’ rights and obligations.”

A number of rules in the area of **offer** should be noted. First, the exporter should be aware that a circular, advertisement, or proposal, considered by him as an invitation to offer, may be construed as a standing offer under the PECL. Article 2.201 states that “a proposal to supply goods or services at stated prices made by a professional supplier in a public advertisement or a catalogue, or by a display of goods, is *presumed* to be an offer to sell or supply at that price until the stock of goods, or the supplier’s capacity to supply the service, is exhausted.”

Second, the **firm offer rule** is expanded to further restrict the maker of an offer's ability to revoke the offer. Unlike Section 2-205 of the UCC, the offer need not be from a merchant, be in writing, be signed, or be for a period less than three months. An offer may not be revoked if it indicates that it is irrevocable or fixes a time for acceptance. Thus, a statement that the offeree must accept within 95 days will be interpreted as a firm offer for 95 days. Under U.S. law, the offer would self-terminate after 90 days and nothing prevents the offeror from revoking the offer prematurely; to be considered a firm offer, the offer must expressly assure the receiving party that the offer will remain open for a fixed period of time. More important, under the PECL any offer may be recognized as a firm offer if it is "reasonable for the offeree to rely on the offer being irrevocable and the offeree has acted in reliance on the offer." Thus, the offer need not give any assurance that it is to remain open.

In the area of **acceptance**, not surprisingly, the common law's dispatch or mailbox rule is rejected for the civil law's receipt rule. Under PECL, a contract is concluded when the acceptance reaches the offeror.¹⁷ It would seem that the receipt rule for acceptance would provide the offeror with an additional period to revoke the offer. But like under Article 18 of the CISG, the right to revoke an offer is frozen when the acceptance is dispatched¹⁸ even though the acceptance is not effective until receipt. However, in the event that the acceptance does not reach the offeror within a reasonable time, then the revocation is unfrozen and prevents the formation of a contract. In the case where a revocation has not already been sent, a late acceptance due to problems of transmission gives the offeror the option to reject the acceptance if he informs the offeree, "without delay," that the offer has lapsed.¹⁹

The **battle of forms** scenario²⁰ commonly found in international sale of goods transactions is dealt with in Article 2.208 titled "Modified Acceptance" and Article 2.209 titled "Conflicting General Conditions." The offeree's form that gives a definite assent to the offer creates a contract unless it possesses additional or different terms that materially alter the offer. Article 2.208 recognizes that the parties can include contract language to control the battle of forms scenario. The offeror may incorporate a clause in its offer to the effect that it "expressly limits acceptance to the terms of the offer."

The offeree may condition its acceptance upon the offeror's assent to its additional terms. Article 2.208 requires that the offeror must expressly agree to the additional terms in order for the conditional acceptance to effectuate a contract. The offeree can obtain an agreement to the additional terms when he requires the offeror to sign and return the conditional acceptance. A conditional acceptance will be treated as a rejection if the offeror's assent to the additional or different terms "does not reach the offeree within a reasonable time." Article 2.209 provides that the fine print terms in offer and acceptance forms will generally be considered as "general conditions" and only the general conditions (standard terms) that are "common in substance" become a part of the contract. Thus, conflicting general conditions would not become a part of the contract.

The PECL also recognize a general area of **precontractual liability** and the duty of good faith negotiations not recognized under U.S. contract law. The very real possibility of unexpected liability will be discussed later in this chapter in the section on Precontractual Instruments. It is sufficient for our current purposes to note that parties have a general duty to negotiate in good faith. Failure to do so, such as never intending to enter into a contract, is grounds for contractual liability. Thus, terminating a negotiation without giving a viable reason is not an appropriate approach. A party can be held liable for losses caused to the other party.²¹ Furthermore, either party to a negotiation may be held liable for a breach of confidentiality.

Article 2.302, titled "**Breach of Confidentiality**," recognizes an affirmative duty not to disclose confidential information obtained in the course of negotiations. Statements made during the negotiations may also provide separate grounds for an action. Article 6.101 ("Statements Giving Rise to Contractual Obligation") states that if a professional supplier gives information about the quality or uses of services or goods when marketing or advertising or otherwise before a contract is concluded then the "statement is to be treated as giving rise to a contractual obligation." This precontractual line of obligation is further extended to agents of the supplier. The supplier is contractually liable for statements made "by a person in *earlier links* of the business chain." It is imperative that the exporter-supplier review his advertisements, promotional brochures, and practices of foreign sales representatives in order to avoid such liability.

A unique feature of the PECL is its coverage of the **agency** relationship. Since the agency relationship is common in international transactions, as in the hiring of a foreign sales representative or distributor, the section on

agency law is appropriate for review. Its coverage of the agency contract is limited to the relationship between third parties and the principal or agent. It does not govern the relationship between the principal and agent. The rules on agency are divided into those governing **direct representation** and those governing **indirect representation**. Direct representation is when the agent acts in the name of the principal. In contrast, indirect representation is when a third party is unaware that the agent is acting as an agent.

The agency rules in the PECL are consistent with most of the agency rules found in the common law. A number of its specific rules are of note. First, in the case where the agent indicates she is acting as an agent, she must identify the principal within a reasonable time of entering into the contract upon the request of the third party. If the agent unduly delays disclosing the principal, then the agent becomes bound by the contract.²² Second, if the third party is in doubt regarding the authority of the agent, “it may send a written confirmation to the principal or request ratification” from the principal.²³ If the principal fails to respond in a timely fashion, the agent’s act is considered authorized by the principal. Agency law is discussed in more detail in Chapter 17 on “Hiring Agents and Distributors”.

In the area of **genuineness of assent**, PECL recognize many of the same contract voiding events found in the common law. The terminology in parentheses is the common law equivalent to the invalidating rule found in the PECL. A party has the right to void a contract due to: Mistake as to Facts or Law (unilateral mistake),²⁴ Mutual Mistake,²⁵ Fraud,²⁶ Threats (duress),²⁷ Unfair Advantage (undue influence),²⁸ and Unfair Terms.²⁹ In the area of mutual mistake, the court is directed not to void the contract but rather to adjust (reform) the contract. It states that where both parties made the same mistake, the court may at the request of either party bring the contract into accordance with what might reasonably have been agreed had the mistake not occurred.

The notion of **economic duress** is not placed under the threats (duress) umbrella but within the notion of unfair advantage (undue influence). A party may avoid a contract if at the time of contracting “it was dependent on or had a relationship of trust with the other party, was in *economic distress* or had urgent needs, was improvident, ignorant, inexperienced, or lacking bargaining skills.” In contrast, the notion that the party had “no reasonable alternative” is found in the article on threats. The article on fraud recognizes a substantial duty to disclose information. The general duty of good faith and fair dealing is also applied to require a duty to disclose under certain circumstances. Factors to be considered in determining the need for disclosure include whether one of the parties had “special expertise,” the cost of obtaining the information, whether the other party could reasonably have acquired the information on his own, and whether the information would have been material to the decision-maker.

The PECL adopt the civil law notion of *nachfrist* notice. The nonperforming party may obtain an extension of the time of performance by giving notice to the other party. Generally, the extension must be given unless the nonbreaching party gives a commercially viable reason for not granting the extension. After the expiration of the extension, the nonbreaching party may terminate the contract even for minor breaches. There is no such provision for requesting or granting additional time in U.S. law.

In the area of contractual excuse for breach, the PECL recognize the notion of **impediment** as a ground to excuse a breaching party for his nonperformance. The test of impediment is similar to that found in the common law excuse doctrines. The impediment must not have been “reasonably expected” and must be beyond the control of the nonperforming party.³⁰ The nonperforming party must give prompt notice of the impediment or be liable for damages resulting from the nonreceipt of the notice. In the event that the impediment is perceived to be temporary in nature, the nonperforming party is not excused from the contract but is granted a temporary suspension of performance.

There are two fundamental differences between the PECL and U.S. law in the area of remedies. First, a unique remedy of **price reduction** is given to the buyer of nonconforming goods. Under the UCC, the buyer may reject nonconforming goods under the **perfect tender rule**,³¹ or may accept the goods, pay in full, and make a breach of warranty claim. The price reduction remedy in the PECL, also found in the CISG,³² allows the buyer to reduce unilaterally the price paid for the goods based on the diminution of value due to the nonconformity. Second, the right to **specific performance** is not considered an extraordinary remedy. Article 9.102 of the PECL states

simply that: “the aggrieved party is entitled to specific performance, including the remedying of a defective performance.” In contrast, the UCC adopts the common law rule that specific performance is warranted only when the goods are *unique*.³³

UNIDROIT Principles of International Commercial Contracts

UNIDROIT is a specialized agency of the United Nations that promotes the unification of law. In May 1994 it published the Principles of International Commercial Contracts (PICC). The PICC’s primary differences from the CISG (see Chapter 12) are threefold. First, it is not for adoption as a domestic law of international contracts. It is intended merely to provide neutral principles acceptable for guidance for lawyers and businesspersons from different legal systems. Second, it provides a set of general principles applicable to all types of contracts. In contrast, the CISG applies only to the commercial sale of goods and supplies a number of specific rules for that type of transaction. Third, the PICC covers contract negotiations, while the CISG deals merely with the mechanics of offer and acceptance.

Those drafting an international contract of any type may want to review the PICC. Although they are nonbinding general principles, some courts may utilize them in the interpretation of an international contract. “With the assistance of the PICC, judges or arbitrators called upon to decide questions of interpretation or to supplement international legislative texts will find it easier to adopt an autonomous and internationally uniform solution.”³⁴ A number of features of the PICC should be noted. The first group of features involves the formation of contracts.

- There is no writing requirement. The PICC simply states that a contract “may be proved by any means, including witnesses.”³⁵ Representations made during the negotiation stage may be entered into evidence even if they conflict with the written contract.
- International trade usage is recognized. The parties are “bound by a usage that is widely known to and regularly observed in international trade.”³⁶
- Article 2.16 recognizes a duty of confidentiality for information obtained during the course of negotiations.
- Article 2.20, titled “Surprising Terms,” provides a means for a party to void fine print terms in a standard form contract. It provides that such terms that a party “could not reasonably have expected” will not be enforced. A conspicuous and clearly written but unusual term is, however, enforceable.

The PICC expressly covers precontractual liability for conduct during the negotiation phase. Along with the potential of liability for bad faith negotiation, the PICC acknowledges the fine line between negotiation and contract in three ways: First, a contract does not require an agreement on all details of the transaction. The fact that no agreement needs to be reached on all details of a transaction implies that parties may not know exactly when they enter a transaction. Article 2.13 suggests that if a party wants to avoid being “dragged” into a contract by surprise, it must specify in advance that agreement on an issue it considers important has to be reached; if no agreement on that specific item is reached, there will be no contract.

Second, sometimes negotiations are not actually finished when one of the parties starts to perform. For instance, the legal departments of the two companies may still be discussing the contract terms when the sales department of the seller already delivers. In such a situation, the shipment of the goods can be considered as acceptance of the offer. Thus negotiations can be overtaken by contract performance. Third, sometimes parties to a contract intentionally leave **open terms**—terms to be agreed on in future negotiations.

One of the great innovations of the PICC is that it provides standards for conducting negotiations. Article 2.15 states that “a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party.” Also, Article 2.16 makes a party liable “when it discloses or improperly uses confidential information obtained in the course of negotiations.” Breach of confidentiality entitles the other party to compensation for either the loss suffered by the breach of good faith or the benefit the party in breach received by disclosing the information.³⁷

Tip 1: Even if not legally required to, put the contract in writing!

Tip 2: Negotiate a choice of law clause.

Tip 3: Custom-design a forum selection or arbitration clause.

Tip 4: Negotiate a specific *force majeure* clause.

Tip 5: Expressly allocate the risk of currency exchange rate fluctuations.

Tip 6: In long-term or multiple installments contracts, negotiate a detailed price escalation clause.

Tip 7: Assure payment and performance through third-party devices such as confirmed letters of credit, standby letters of credit, performance bonds, and bank guarantees.

Tip 8: Seek the expert advice of international lawyers, foreign legal counsel, international bankers, freight forwarders, customs brokers, insurance brokers, and governmental agencies.

Figure 11.6 *Focus on Transactions*: Practical Tips for International Contracting.

The PICC is indicative of how most civil law legal systems are likely to affix liability in the negotiation stage. Parties are generally required to act in good faith during the negotiation phase. For example, a termination of lengthy negotiations without a justified reason will be considered bad faith and subject the party to a suit for damages or expenses. Such precontractual liability may include claims for expenses directly related to the negotiations, including travel, research, and consulting expenses. It may also support a claim for indirect damages such as lost profits from other potential deals that the innocent party gave up to pursue negotiations with the terminating party. The Civil Code countries make a distinction between mere negotiations and preliminary agreement. The line between the two is a very subtle one. In addition, the Civil Code countries provide for extended periods of time for the bringing of lawsuits. Under the Italian Civil Code, the statute of limitations to bring a breach of the duty of good faith negotiations is five years, extended to ten years for a breach of contract. In contrast, there is no cause of action in the United States for bad faith negotiation, while the statute of limitations under Section 2-725 of the UCC is four years and the contracting parties are authorized to reduce the period to as little as one year.

In the area of performance, the PICC includes a section on **hardship**. Hardship is defined as “where the occurrence of events fundamentally alters the equilibrium of the contract.”³⁸ In order for a party to claim a hardship, he must show that the event causing the hardship could not reasonably have been taken into account at the time of contracting, that the event was beyond his control, and that the party did not assume the risks of the event occurring. Hardship allows the party to “request negotiations.” In the event that the parties do not agree to an adjustment or settlement, the court is instructed to either terminate the contract or adjust the contract to restore its equilibrium (Article 6.2.3). Figure 11.6 *Focus on Transactions*: “Practical Tips for International Contracting” provides a number of practical tips for international contracting.

Precontractual Liability

As noted above, under U.S. common law, a negotiating party owes no duty of good faith to the other party. One may terminate negotiations in bad faith and not be liable for the other party’s expenses, with one major exception: *Reliance theory*, often referred to as **promissory estoppel**, may be used to extend contractual liability to protect someone who reasonably relied upon the belief that the parties would conclude a final agreement. Section 90 of the *Restatement (Second) of Contracts* allows a court to give a remedy if a person’s promise is reasonably relied upon and injustice can be prevented only by the enforcement of the promise.

The court, in *Nimrod Marketing v. Texas Energy Corp.*, held that a purchasing agent who expended money in reliance of obtaining a contract from one of its clients could sue for damages when the client elected to use another purchasing agent. The client had sent a letter to the agent that stated: “Acting pursuant to your responsibilities as our purchasing agent, it is our hope to begin construction of the housing shortly upon obtaining a contract with the foreign government.” The court ruled that based upon the doctrine of promissory estoppel, the agent had reasonably relied upon the assurance in the letter. See also, Figure 11.7 *Focus on Transactions*: “Reliance Factors: Liability for Oral Statements and Informal Business Letters.”

Nimrod Marketing Ltd. v. Texas Energy Investment Corp.**769 F.2d 1076 (5th Cir. 1985)**

Defendant (Texas Energy) was under a contract with a foreign government to build low-cost housing, and plaintiff (Nimrod) was Texas Energy's purchasing agent for supplies and materials. After Nimrod started acquiring materials, Texas Energy withdrew from its contract with the foreign government. Nimrod brought a claim under the theory of promissory estoppel. The lower court awarded damages. The court held Texas Energy liable for damages, since they had knowledge of the special circumstances producing damages upon its breach of the (non-contractual or non-binding) agreement.

Politz, Circuit Judge: Nimrod Marketing (Overseas) Ltd. and its president, Tom Anderson-Slight, sued Texas Energy for cancellation charges and expenses resulting from a breach of a purchasing agent agreement. The district court found liability based on the doctrine of promissory estoppel and awarded damages.

Facts

Texas Energy, a Texas-based oil trading company under contract with the Nigerian government, formed a joint venture with Nigerian investors to build low-cost housing for Russian steelworkers in Nigeria. In furthering the venture, Texas Energy and the Nigerians formed a partnership named Advanced Technology Ltd (ALT).

The partners were immediately confronted with the complex task of getting building materials, equipment, and supplies into Nigeria and arranging for payment with Nigerian funds. In May of 1981, William Houston, construction superintendent for Texas Energy, on an airplane found himself serendipitously seated next to Tom Anderson-Slight, president of Nimrod. Nimrod, an international trading company with extensive experience in international trading, had had numerous dealings in West Africa. Upon learning of Texas Energy's need for help in the purchasing and shipping of goods to Nigeria, Anderson-Slight told Houston of his company's expertise and expressed an interest in acting as Texas Energy's purchasing agent for the Nigerian project. Thereafter, Texas Energy and Nimrod managers met in London to discuss the project in depth. Texas Energy provided a list of needed supplies including equipment, construction material, food, and living quarters. Following those meetings, Nimrod provided price quotes for items on the list.

In late August, Anderson-Slight met in Houston with senior officials of Texas Energy to explain the

documentation necessary for shipments to Nigeria. During the visit, purchase orders, dated September 1, were issued by ALT. Items were color-coded to reflect priority in shipment. The initial purchase orders covered items color-coded green, indicating those items to be shipped immediately. During this visit Anderson-Slight was given two "comfort letters" (comfort letters are non-binding promises or assurances), appointing Nimrod as purchasing agent for the Nigerian project for Texas Energy and ATL.

A. Promissory Estoppel

Acting pursuant to the comfort letters, purchase orders, and verbal authorizations Nimrod began acquiring equipment and materials from its suppliers. In addition, Nimrod incurred expenses for several trips to Nigeria. Several weeks later, on October 31, Texas Energy representatives informed Nimrod that because of a disagreement over financing with their Nigerian partners they were withdrawing from the project. Nimrod filed suit seeking damages for expenses and charges incurred in cancelling the contracts with its suppliers. They grounded their claims on promissory estoppel.

The trial court rendered judgment in favor of Nimrod on a finding that they had relied on the "comfort letter" of September 1 to their detriment. Damages for cancellation charges and out-of-pocket expenses incurred after receipt of that letter were awarded. In computing the cancellation charges the trial court applied the monetary exchange rate for British pounds sterling into United States dollars applicable on the date of the breach of the agreement. The exchange rate at that time was \$1.90/1 pound sterling. The exchange rate on the date of final judgment, January 26, 1984, was \$1.4045/1 pound sterling. The rate has obviously varied markedly in the time period involved.

B. Recovery of Cancellation Charges

Texas Energy argues that the court erred in allowing recovery for cancellation charges because those charges had not been paid to Nimrod's suppliers as of the date of trial. The suppliers had apparently agreed to defer their claims pending the outcome of the instant litigation. Appellants maintain that the damages awarded for the cancellation charges were speculative and contingent. We find this argument without merit.

Under well-settled Texas law, losses resulting from collateral contracts are recoverable in an action for breach of contract if the breaching party “had knowledge of the special circumstances producing such damages.” Texas Energy was aware that Nimrod promptly began placing orders for supplies, equipment, and material pursuant to the September 1, 1981 comfort letter and the written and oral purchase orders for such goods. They clearly had knowledge of the special circumstances producing damages upon their breach of the purchasing agent agreement.

C. Rate of Exchange

Texas Energy and ATL contend that the district court erred in its calculation of damages in dollars. They maintain that the court should have converted the amounts due the three suppliers in British pounds sterling into dollars as of the date of judgment, not the date of the breach. We agree that the trial judge erred in this respect.

Recovery under the theory of promissory estoppel is limited to “the amount necessary to compensate that party for a loss already suffered.” The judgment of the district court is **AFFIRMED**.

Case Highlights

- Promissory estoppel, a creation of the common law, allows recovery of out-of-pocket expenses (reliance damages), but not for loss profits, which would be the case under a breach of contract theory (expectation damages) since there is no formal contract to enforce.
- Section 90 of the American Restatement of Contracts provides three requirements, which must be proved in order to collect under promissory estoppel: (1) an assurance or promise, (2) the other party’s reasonable reliance on that assurance (incurs expenses), and (3) an injustice would be done unless the court provides some sort of remedy (reliance damages). All three of these requirements exist in the *Nimrod* case: (1) Texas Energy made assurances to Nimrod that it would use Nimrod to procure materials for its Nigerian project; (2) Nimrod moved quickly, based on the assurance, to prepare for delivering the supplies (prepared engineering drawings, purchased cargo space on ships, ordered materials from its suppliers), especially since Texas Energy was “confronted with the complex task of getting building materials, equipment, and supplies into Nigeria” in order to complete the project on time; and (3) it would be unjust to have Nimrod bear the costs it incurred on behalf of Texas Energy.
- The party causing the harm should not benefit from the good faith of others such as the willingness of Nimrod’s suppliers to delay demand of cancellation charges related to Nimrod’s orders until the conclusion of the litigation.
- Promissory estoppel focus is not on the person giving the promise, but on the actions or expectations of the party receiving the promise. Promissory estoppel is based not on promise theory (as in breach of contract; breach of promise), but is based on reliance theory, which is why it is called “detrimental reliance” in Section 90 of the Restatement. See Figure 11.7 *Focus on Transactions*: “Reliance Factors: Liability for Oral Statements and Informal Business Letters” for a review of some of the “reliance factors” that courts use to determine if the promise-giver should be liable for damages.
- Preliminary agreements or comfort letters generally are not sufficient to form a contract, but they may be the basis for a promissory estoppel claim.
- In order to succeed on a promissory estoppel claim the plaintiff must show that it reasonably relied on the defendant’s promise or assurance to its detriment.
- The damages awarded in promissory estoppel are limited to the out-of-pocket or reliance damages of the relying party. A party may not recover lost profits under promissory estoppel.
- In calculating damages an important factor for the court is deciding the applicable currency and exchange rates, as well as the appropriate time when the conversion is to be made.

The *Nimrod* case above and the *R.G. Group* case below examine the use of promissory estoppel to collect damages due to a promise or assurance of a future contract between business parties. Promissory estoppel is used when no formal contract is formed. Another issue in the area of precontractual liability is whether preliminary agreements are enforceable. The theory here is one of breach of contract: At what point do negotiations result in a binding contract? A third issue is whether the parties have a duty to negotiate in good faith or do they have the right to break off negotiations at any time without liability?

- | | |
|---------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------|
| 1 Does the language in the statement or letter border on a promise or a guarantee? | 6 What was the relative sophistication of the parties regarding the purpose or legality of the statement or letter? |
| 2 Is there a disclaimer of liability in the statement or letter? | 7 What were the prior dealings between the parties regarding such letters or statements? |
| 3 Does the statement or letter invite one of the parties to take steps to ensure performance of an underlying obligation? | 8 What is the custom or practice in that particular business or industry regarding the purpose and legality of such statements or letters? |
| 4 What was the intent of the party giving the statement or letter? | 9 What was the length of negotiations pertaining to the statement or letter? |
| 5 Did either party receive legal advice as to the legality of the statement or letter? | 10 Was there actual reliance upon the statement or letter? |

Figure 11.7 *Focus on Transactions*: Reliance Factors: Liability for Oral Statements and Informal Business Letters.

The *R.G. Group, Inc. v. Bojangles'* case provides an example of when negotiations and preliminary writings do not lead to contractual liability. It also introduces the reader to the concepts of the statute of frauds and promissory estoppel. The former is an obstacle to contract formation and the latter is an alternative avenue of liability.

As the *R.G. Group, Inc.* case demonstrates, contractual liability under U.S. law becomes vested only when the parties move beyond mere negotiations. The importance of the line between negotiations and contract was more recently explored in *Novecon Ltd. v. Bulgarian-American Enterprise Fund*.³⁹ A Federal Appeals Court held that no contract was formed when one party responded to a letter from a second party by stating that it agreed to the terms of the second party's proposal. The case involved Novecon, a company that develops business projects in Bulgaria. Novecon proposed a joint venture for a construction project in Sofia on land owned by Batsov, which was to get a share of the project for contributing land. A construction loan was to come from Bulgarian-American Enterprise Fund (BAEF). There were four letters between Novecon and BAEF concerning who would have what responsibility for the project. BAEF's last letter said that there were unresolved issues with Batsov that had to be settled

R.G. Group, Inc. v. Bojangles' of America, Inc.

751 F.2d 69 (2d Cir. 1984)

Pratt, Circuit Judge. Plaintiff R.G. Group, Inc., claim to have made an oral agreement with the defendants, Bojangles' of America, Inc., and its parent corporation, The Horn & Hardart Company, in which plaintiff gained the exclusive right to develop and operate some twenty "Bojangles' Famous Chicken 'N Biscuits" fast-service restaurants. Sometimes an oral promise or handshake is all that is needed, but when substantial sums of money are at stake it is neither unreasonable nor unusual for parties to require that their contract be entirely in writing and signed before binding obligations will attach. This case does not even present much of a cautionary tale. Its lesson is simply that when experienced businessmen and lawyers are told explicitly and clearly that a major and complex agreement will be binding only when put in writing, then they should be rather cautious about assuming anything different.

Bojangles' gave Gillman of R.G. Group a copy of its standard form development franchise agreement. Its general provisions include requirements that the entire agreement, and any modifications, be in writing and signed by the parties: "This Development Franchise Agreement together with all the Appendices and Exhibits annexed hereto contain the entire agreement and understanding between the parties hereto with respect to the subject matter hereof and supersedes all prior negotiations and oral understandings between the parties hereto, if any. There are no agreements, representations, or warranties other than those set forth, provided for or referred to herein." ["Lawyer Talk": Remove the hereto, hereof, and herein from the contract provision and note that there is no change in meaning, but an increase in clanty!] Gillman testified that he had asked Bojangles' representative Schupak over the telephone, "Do we have a handshake deal?" Schupak's answer, according to Gillman, was "Yes, we

have a handshake deal today and right now.” The agreement, however, was never signed. On December 14, 1982, Schupak called Gillman and told him that Bojangles’ franchise committee had refused to approve the application put together by Gillman.

A. Was There a Contract?

Under New York law, if parties do not intend to be bound by an agreement until it is in writing and signed, then there is no contract until that event occurs. This rule holds even if the parties have orally agreed upon all the terms of the proposed contract. On the other hand, where there is no understanding that an agreement is binding until reduced to writing and formally executed, and “where all the substantial terms of a contract have been agreed on, and there is nothing left for future settlement,” then an informal agreement can be binding even though the parties contemplate memorializing their contract in a formal document. The point of these rules is to give parties the power to contract as they please, so that they may, if they like, bind themselves orally or by informal letters, or that they may maintain “complete immunity from all obligation” until a written agreement is executed. Hard and fast requirements of form are out of place.

Freedom to avoid oral agreements is especially important when business entrepreneurs and corporations engage in substantial and complex dealings. In these circumstances there are often forceful reasons for refusing to make a binding contract unless it is put in writing. The actual drafting of a written instrument will frequently reveal points of disagreement, ambiguity, or omission, which must be worked out prior to execution. Details that are unnoticed or passed by in oral discussion will be pinned down when the understanding is reduced to writing. These considerations are not minor; indeed, above a certain level of investment and complexity, requiring written contracts may be the norm in the business world, rather than the exception.

To begin with, it is not surprising that considerable weight is put on a party’s explicit statement that it reserves the right to be bound only when a written agreement is signed. A second factor of major significance is whether one party has partially performed, and that the party disclaiming the contract has accepted performance. A third factor is whether there was literally nothing left to negotiate or settle, so that all that remained to be done was to sign what had already been fully agreed to. A fourth factor is whether the agreement concerns those complex and substantial business matters where requirements that

contracts be in writing are the norm rather than the exception. In the present case the evidence on each of these factors unequivocally supports Bojangles’ position. There was, first of all, the explicit wording of the development franchise agreement itself, which declared on its face that “when duly executed” it would set forth the parties’ rights and obligations.

Here there was no performance, partial or otherwise, by either party. The third factor—whether there was literally nothing left to agree to—supports defendants’ position as well. Winarick, R.G. Associates’ chief operating officer, admitted in a deposition that the territory issue to be decided was an important one. The fourth factor concerns the extent to which, as a practical business matter, the agreement involved a scale of investment and complexity such that a writing requirement would be expected. Certainly this is the kind of agreement where it would be unusual to rely on an oral understanding. Bojangles’ franchise contracts run for twenty years and cover detailed matters of capital structure for franchisees, purchase and development of real estate, construction of stores, trade secrets, transfer of interests, and rights on termination or default.

B. The Statute of Frauds

The district court also decided that even if there had been an oral agreement, it would be rendered void by the New York statute of frauds. That statute provides in relevant part: “Every agreement, promise, or undertaking is void, unless it or some note or memorandum thereof be in writing, if such agreement, promise, or undertaking by its terms is not to be performed within one year from the making thereof.” The required memorandum may consist of several documents, only some of which are signed, provided that they clearly refer to the same transaction.

Plaintiff argues that four documents, taken together, contain all the terms of the alleged contract. The writings put forward by plaintiffs, however, contradict the alleged oral agreement. Although plaintiffs rely in part on the standard form development franchise agreement to satisfy the statute, that agreement states that it is effective only when signed, that any modification or amendment to it must be in writing, and that any agreement concerning its subject matter must be in writing and signed. Our conclusion, therefore, is that the district court was correct in holding that there is no triable issue concerning plaintiffs’ failure to satisfy the statute of frauds.

C. Promissory Estoppel

Plaintiff also argues for recovery on the basis of promissory estoppel. In New York a claim for promissory estoppel requires “a clear and unambiguous promise; a reasonable and foreseeable reliance by the party to whom the promise is made; and an injury sustained by the party asserting the estoppel by reason of his reliance.” However, there never was “a clear and unambiguous promise” to plaintiff that the development franchise was theirs. Plaintiff’s counsel admitted in hearings before the district court that “the vast bulk” of plaintiffs’ expenditures were made prior to December 3, the date of the alleged promise. Hence the district court was correct in rejecting the promissory estoppel claim both for lack of a clear promise and for lack of reliance. AFFIRMED.

Case Highlights

- If parties do not intend to be bound by an agreement until it is in writing and signed, then there is no contract until that event occurs.
- An informal agreement can be binding even though the parties contemplate memorializing their contract in a formal document.
- It is good business practice to place an agreement in writing because the writing will frequently reveal points of disagreement, ambiguity, or omission that should be worked out before entering a contract.
- A court will weigh a number of factors to determine whether the parties intended to be bound before entering into a formal written contract, including whether one party reserved the right to be bound prior to a formal agreement, whether there has been a partial performance, whether there were still outstanding issues, and the complexity of the agreement.
- The statute of frauds requires any contract that cannot be performed within one year to be in a signed writing.
- Promissory estoppel is not available to recover expenses incurred before the making of a promise.

before the matter could be finalized. Novecon replied that it accepted the terms of the offer, and that it understood that BAEF would resolve matters with Batsov.

Negotiations between BAEF and Batsov did not go well, and BAEF withdrew from the project. Novecon sued for breach of contract. The court granted BAEF summary judgment. It stated that “for an enforceable contract to exist there must be both (1) agreement as to all material terms and (2) intention of the parties to be bound.” The court held that there was no contract by reasoning that BAEF merely extended an offer to negotiate when it said that matters with Batsov needed to be resolved as a necessary part of any agreement. Parties “will not be bound to a preliminary agreement unless the evidence presented clearly indicates that they intended to be bound at that point.” The exchange of communications did not constitute an agreement but were merely a part of the preliminary negotiations.

Examining the legal system of the Federal Republic of Germany allows us to compare how other legal systems deal with the potential liability of precontractual correspondences and instruments. German law is less dependent than U.S. law upon the literal designation of writings or instruments as legal or nonlegal. This informalism provides parties greater flexibility in structuring transactions. The German courts look to the purpose of a letter or a writing to determine if it creates an enforceable contractual obligation. One might argue that even informal business letters, seemingly not binding on the surface, are more likely to have legal consequences under this purpose-oriented approach to enforceability. The presumption is that most businesspersons would not spend time negotiating and drafting letters and documents unless they believed them to be legally binding. German and French courts often ask the following question when reviewing an instrument for enforceability purposes: Would two sophisticated commercial entities spend time to create a meaningless, unenforceable instrument?

Culpa in Contrahendo

The famous case of *Texaco v. Pennzoil*⁴⁰ illustrates that simply knowing the black-letter rules of contract may not be enough to avoid liability. In that case, Getty and Pennzoil reached an “agreement in principle” and held a news conference announcing the tentative agreement. Before the parties had not entered a formal agreement, subsequently Getty entered into a formal contract to sell to Texaco. Despite the fact that the sale of Getty Oil to

Pennzoil was never finalized, Texaco was held liable for tortious interference of contract for its attempt to buy Getty. A jury awarded Pennzoil \$7.53 billion in compensatory damages and an additional \$3 billion in punitive damages. Texaco subsequently filed for bankruptcy protection before settling out of court. Pennzoil and Getty had entered into a “memorandum of agreement” but a final, formal agreement was never signed. Furthermore, industry custom indicated that the term *agreement* is different than the term *contract*. Thus, such memorandums were generally considered preliminary and conditional on the signing of a formal contract. Nonetheless, the jury found there was a contractual “meeting of the minds” and that but for the interference by Texaco, the parties would have signed a formal contract.

The *Texaco* case also serves to illustrate the importance of contract negotiations and the dangers of acting in bad faith during those negotiations. Unlike in the United States, the idea of precontractual liability is accepted in most of the world’s national legal systems. In the civil law, one form of precontractual liability, *culpa in contrahendo*, has been a firm part of contract and tort laws. This liability is generally premised on the implied duty of the parties to act in good faith during the negotiations of a contract. In contrast, the American Uniform Commercial Code mandates good faith only during the performance and enforcement of contracts. Good faith under the civil law system means more than not breaking off negotiations in bad faith. Numerous duties are assigned to the negotiating parties. Under Dutch law there are duties to disclose essential information, to investigate in order to obtain necessary information, and to refrain from negotiating with third parties. A Dutch court in *Plas v. Valburg, Hoge Road*⁴¹ divided pre-contract negotiations into three different stages.

Plas v. Valburg, Hoge Road

18-6 Nederlandse Jurisprudentie 723 (1983)

A construction firm, Plas, submitted a tender or bid to build a municipal swimming pool in the Town of Valburg. Its proposal was considered to be the best one by the Mayor and his municipal councilors agreed to the plan. The proposal was within the budget made available for the project. However, the City Council rejected the recommended bid in favor of an alternative tender by another company at a lower price. Plas sued for expenses and damages.

The court held that there are three steps in most contract negotiations that result in the creation of numerous rights and duties. During the initial stage of negotiations either party is free to break off negotiations without any liability to the other party. The next stage or “continuing stage” of negotiations allows either party to break off negotiations, but the breaking off party remains obligated to compensate the other party for at least some of its expenses. These types of damages are grounded upon Dutch tort law. In short, the breaking off of negotiations is deemed to be a tortious act.

During the third and final stage of negotiations the parties are not free to break off negotiations. To do so would be considered within the doctrine of *culpa in contrahendo* or an infringement of the rules of good faith. This stage is entered into when the parties mutually and

reasonably expect that in any case a contract of some kind would result from the negotiations. The breaking off party is obligated to pay for the expectancy damages of the other party. These damages include any expenses incurred and, if deemed appropriate, the profits that would have been made by that party.

Decision. The parties had not entered into the third or final stage of negotiations. Therefore, it is inappropriate to award Plas damages for lost profits. The negotiations had entered into the second or continuing stage and therefore, Plas is awarded damages to cover the expenses incurred in preparing its bid proposal.

Case Highlights

- The preliminary or initial stage of negotiations result in no legal liability.
- Bad faith termination during the second or continuing stage of negotiations results in a claim for out-of-pocket expenses or what in U.S. contract law are referred to as reliance damages.
- The parties are prohibited from terminating negotiations during the third or final stage of negotiations without being liable for full contract damages, known under U.S. law as expectancy damages.

What types of expenses are the terminating party liable for under *Plas v. Valburg*'s second stage? These expenses include costs that can be connected directly to the negotiations, including travel and estimating expenses and possibly damages that result from the fact that the prejudiced party was not able to conclude a contract with a third party during the negotiations. Under German law, to find a party liable for breaking off negotiations it would have to be shown that the party breaking off negotiations: (1) indicated to the other party that the negotiations would lead to a conclusion of a contract and (2) failed to give a commercially reasonable explanation for the termination. German law also allows for liability for bad faith negotiation even when a contract is concluded; in short, when one of the parties' reasonable expectations are not satisfied. This type of liability includes cases involving the non-disclosure of essential information. Under U.S. law, the ordinary means of redress would be the tort of intentional misrepresentation or fraud.

Article 1337 of the Italian Civil Code states that "the parties, in the conduct of negotiations and the formation of the contract, shall conduct themselves according to good faith." The *Grifoni v. Euratom* case examines the Italian version of *culpa in contrahendo* as stated in Article 1337.

It is important for U.S. businesspersons to understand the potential for precontractual liability in international business dealings. First, there is no true counterpart to such liability in the common law system. Thus, what are considered *mere negotiations* in U.S. law can lead to unexpected legal liability in international business negotiations. Second, the effect of damages granted for a bad faith termination of negotiations can be catastrophic. Under the doctrine of *culpa in contrahendo*, a court has the authority to grant full contract damages, including lost profits.

Grifoni v. Euratom

Energy Community (Euratom) [1992] 3 CMLR 463

In the context of a tendering procedure for the performance of certain tin-plating and iron work to be carried out at the Euratom Research Center, the applicant, following Euratom's invitation to tender, submitted an offer, which was accepted by Euratom. A precontractual agreement was concluded governing the future relations between the parties including the following clause: "the successful tenderer has the sole responsibility to ensure that safety rules are obeyed and that order is maintained on the work site." Soon thereafter, the applicant climbed on to the roof of the Research Center in order to take measurements. The applicant fell from a height of 4.5 meters and suffered serious injuries.

Opinion of Sig Giuseppe Tesauro. The accident occurred when the contract was not yet in force. It follows that contractual liability is precluded. However, it remains to be considered whether it is possible to find in Italian law, which is applicable by virtue of the precontractual agreement, and in particular in Section 1337 of the Italian Civil Code, a precontractual liability or *culpa in contrahendo*. Section 1337 provides that "in the negotiations and in the drawing up of the contract the parties shall

act in good faith." As a matter of general legal theory, for precontractual liability to exist there must be some practical relationship with the subject-matter of the future contract, a relationship against which the traditional obligation of good faith is measured. A textbook example is the seller who significantly reduces the value of the object while negotiations are still in progress, or the party who unreasonably breaks off the negotiations. In the present case, the relationship between the event in question and the contract is merely chronological inasmuch as the event occurred prior to the entry into force of the contract. Consequently, it appears that in the present case neither contractual nor precontractual liabilities were established.

Case Highlights

- The incurring of damages in relationship to negotiating a contract does not automatically lead to precontractual liability.
- The precontractual agreement shielded the owner from any liability relating to accidents and was enforceable against a claim for personal injuries.

One of the most common and important contracts that an exporter or manufacturer enters is with a foreign distributor for its products. This contract and relationship is vital to the successful marketing, sales, and distribution of products into a foreign market. The *SA Pasquasy v. Cosmair, Inc.* case deals with the negotiation of an exclusive distribution agreement.

SA Pasquasy v. Cosmair, Inc.**[1989] ECC 508**

Where one party to negotiations with a view to entering an exclusive distributorship agreement, without valid reason breaks off negotiations just as they are about to be completed, he is at fault and incurs liability in damages. This is especially the case where the party knowingly allows the other party to incur considerable expense in order to be ready to perform his side of the contract and where both parties had clearly expressed their intention to enter into a permanent relationship. The facts of the case showed that the final version of the distribution agreement was at the point of being signed and that the correspondence between the parties showed that there was consensus on the essential elements of the agreement.

We find for the plaintiff on the tort claim of *culpa in contrahendo*. Furthermore we hold L'Oréal to be jointly liable with its subsidiary, despite the fact that it took no part in the negotiations itself, because the facts show that it induced its subsidiary to break off the talks. The plaintiff claims the following damages: (1) advertising expenses incurred in the promotion of defendant's products, (2) investments related to carrying out the expected contract, and (3) loss of opportunity. We find that the advertising expenses were reasonable and necessary because the products in question were unknown in Belgium and Luxembourg.

The plaintiff claims that it purchased a building, along with office equipment and a new computer system, in order to service the new distributorship agreement. It seeks to recover three years of the depreciation value (term of the distributorship) of these investments. Claims for damages are restricted by two principles. First, the damages must be assessed *in concreto* (certain, not speculative). Second, the victim is obligated to do everything to keep his damages to a minimum (duty to mitigate).

The facts indicate that the plaintiff had acquired other distributorships that are also serviced by the new investments. We hold that the expenses in question do not appear to constitute injury having a necessary causal connection with the defendants' fault. Also, by acquiring new distributorships the plaintiff has been able to make a profit on its investment and therefore there is no damage.

Finally, plaintiff claims the loss of the opportunity of obtaining the profit anticipated by the grant of the distributorship for three years. In conformity with the prospective agreement and during the negotiations sales had already commenced over a period of ten months. The plaintiff estimates that its minimum loss profit amounts to 15 percent of the planned sales quota for the three years. We believe that 8 percent is more realistic because the plaintiff agreed to bear a number of expense items. Also, the profit would have accrued over the three-year period of the agreement. Therefore, two-fifths should be reduced from the total amount of the calculated profits. JUDGMENT of 8,864,788 Belgian francs for the plaintiff.

Case Highlights

- Elements that favor an award in *culpa in contrahendo* include the suddenness of the termination, the finality of the negotiations, and knowingly allowing the other party to incur expenses.
- The nonterminating party is entitled to expenses and investments incurred in preparing to perform the contract, along with damages related to lost opportunity or profits.
- The nonterminating party's claims for damages are limited to losses that are provable with certainty and by its duty to mitigate.

Precontractual Instruments

The above section noted the issue of the use of precontractual agreements and whether liability can result from such agreements. This section reviews in more depth the legal significance of preliminary writings, correspondences, and precontractual instruments. Precontractual instruments are found in most areas of trade and finance; examples include letters of intent, letters of support, and letters of assurance. For want of a better term, they will be referred to as **comfort instruments**.⁴² Comfort instruments are generally given to encourage another party to enter into a contractual obligation. They may be made in conjunction with the direct negotiations between the parties or by a third party to the negotiations. For example, a parent company may send a letter of assurance or support "encouraging" a bank to lend money to its subsidiary. The issue becomes whether such informal letters can lead to contractual liability.

The potential for contractual liability lies in the internal inconsistency of many of these instruments. The typical comfort instrument tries to offer a guaranty-type of assurance without the resultant guaranty-type of liability. The 1923 English case of *Rose & Frank Co. v. Crompton*⁴³ is one of the earliest instances of a court coming to terms with a comfort instrument's internal contradiction. The Court expressly recognized the doctrinal inconsistencies in the language of the letter. It weighed the assurance language with the disclaimer language, ultimately deciding that the disclaimer language was the more dominant. It determined that the operative phrase in the letter was that it was a *contract of honor* and mere loss of honor is not a basis for contractual liability. The line between contract and noncontract remains ambiguous. The question of enforceability provides a framework for analyzing the twin pillars of contract: promissory intent and promisee reliance.

Judge Vaisey in *Chemco Leasing Spa. v. Rediffusion Plc.* sarcastically frames the issue of comfort instrument enforceability. It is a “*gentlemen's agreement*, which is not an agreement, made between two persons neither of whom is a gentlemen, whereby each expects the other to be strictly bound without himself being bound at all.”⁴⁴ If this is true, then there is little ground for enforcement under either express intent or reliance. On its face, the instrument's ambiguous nature would make it difficult to find the requisite intent subjectively or objectively. The recipient of the comfort instrument would be hard pressed to prove justifiable reliance.

Internationally, courts have been more likely to enforce such instruments. The civil law system, for instance, seems to place less weight on the semantic labeling of instruments when determining the existence of a legally enforceable obligation. The lack of dependency upon legal literalism, both in the labeling of instruments and in the words of art used within the instruments, allows for greater flexibility in affixing contractual liability than is found in the common law system. For example, in the Federal Republic of Germany there are no specific provisions in the Civil or Commercial Codes concerning contractual guarantees. U.S. contract law would hold that comfort instruments are unenforceable because they lack clear contractual intent. French jurisprudence renders a contrary presumption, finding that such comfort instruments possess an implied intent to be binding *obligations de faire* (contracts). The presumption is grounded in the belief that parties generally do not intend to create meaningless contractual-type documentation.

Consumer Contracts

Contracts are categorized into two types: (1) business-to-business (B2B) or commercial contracts and (2) business-to-consumer (B2C) or consumer contracts. Other than an assortment of consumer protection laws, the general law of contracts applies to both types of contracts. This is especially true of countries in the common law system, such as the U.S. However, in some legal systems, most notably in the European Union (EU), a separate body of contract law has been formed that can be labeled as **consumer contract law**. These specialized bodies of consumer contract laws are important to exporters and importers of goods in which the ultimate purchaser is a consumer. It has become increasingly important with the rapid expansion of Internet sales.

European Union Consumer Law Acquis

The European Union has long required special rules to protect consumers in contracts with merchants. They have passed numerous laws in this area, most notably the Directive on Unfair Terms in Consumer Contracts 1993. See Figure 11.8 *Comparative Law*: “Key Points in EU Directive 93/13/EEC on Unfair Terms in Consumer Contracts.” Subsequently, it has increasingly viewed consumer contracts differently than commercial contracts through the passage of more and more laws that seek to protect consumers. This body of law is referred to as the consumer law *acquis*. More recently, the EU enacted the Consumer Rights Act of 2015, which consolidates the previous **consumer protection laws**. It also gives consumers a number of new rights and remedies, and has provisions for **alternative dispute resolution (ADR)** that came into force on July 9, 2015.

Acquis or **acquis communautaire** is the accumulated legislation, legal acts, and court decisions, which constitute a body of EU law. *Acquis* is defined in French as “that which has been acquired or obtained,”

- A non-negotiated term is unfair when it establishes a significant imbalance, to the consumer's detriment, between the rights and obligations of the contracting parties.
- Assessing the unfair nature of a contractual term takes into account:
 - i The nature of the goods or services covered by the contract;
 - ii the circumstances surrounding the drawing up of the contract;
 - iii the other terms in the contract or in another contract to which it relates.
- Neither the definition of the main aim of the contract nor the relationship between the price and the service or goods to be provided may be taken into account in assessing the unfair nature of clearly worded contractual terms.
- Where there is doubt as to the meaning of a term, the interpretation most favorable to the consumer will prevail.
- Consumers are not bound by unfair terms in a contract signed with a professional.

Figure 11.8 *Comparative Law*: Key Points in EU Directive 93/13/EEC on Unfair Terms in Consumer Contracts.

The 2013 Fair Trading Act, in New Zealand, bans unfair terms in consumer contracts. The regulations relating to this Act form part of the "Consumer NZ" "Play Fair" campaign to increase awareness of the new law and related consumer issues. The Act will apply to standard-form consumer contracts.

What makes a term "unfair"? The Act defines an unfair term as one that would "would cause a significant imbalance between the rights of the company and the consumer, is not reasonably necessary to protect the legitimate interests of the company, or would cause detriment to the consumer if it were to be applied or relied on." The Act contains a list of terms that courts are likely to regard as unfair. For example:

- terms that would allow a company to unilaterally vary the terms of the contract;
- terms that would allow a company to unilaterally renew or terminate the contract;
- terms that would penalize consumers for breaching or terminating the contract;
- terms that would allow a company to vary the price without giving consumers the right to terminate the contract; and
- terms that allow a company to vary the characteristics of the goods or services to be supplied.

Even though this Act is a consumer protection device, only the New Zealand Commerce Commission can, for now, enforce it. The contemplated fine for violations is \$600,000.

Figure 11.9 *Comparative Law*: 2013 New Zealand Fair Trading Act: Unfair Terms in Consumer Contracts.

and *communautaire* as "of the community." Thus, laws dealing with consumers' make-up the consumer law *acquis*. All of European Union law would simply be the EU *acquis*. For a review of a common law country bypassing the common law and enacting a European-style consumer contract law relating to "unfair terms," see Figure 11.9 *Comparative Law*: "2013 New Zealand Fair Trading Act: Unfair Terms in Consumer Contracts."

The New Zealand law, and the EU Directive on Unfair Contracts, are what are known as standard forms or standard terms regulations. Most of modern business is transacted using standard forms and within these forms are "boilerplate" or fine print terms, which consumers fail to read or even if they are read the consumer may fail to understand them. The above laws seek to prevent companies from abusing their power to insert abusive terms in consumer contracts. Although the U.S. has consumer protection laws that deal with specific issues, and the UCC has protective rules for some terms (liquidated damages, limitation of remedy, and limitation of liability terms)⁴⁵, the U.S. has no general regulations for consumer contracts. The model of the common law and UCC is that there is only one contract law (common law of contracts) that applies equally to commercial and consumer contracts. The only tool that American courts have to void enforcing abusive terms is the **doctrine of unconscionability**. The doctrine of unconscionability allows courts to void or change contract terms that are unusually harsh and that "shock the conscience," meaning they are so grossly unfair (substantive unconscionability) that they could only have been possible through the abusive use of one-sided bargaining power (procedural unconscionability).

Consumer Contract Law in the United States

In the U.S., the idea of a separate consumer contract law has been rejected. However, in the sale of goods, there is what is known as the merchant–consumer distinction found in Article 2 of the Uniform Commercial Code (UCC). Karl Llewellyn, the drafter of Article 2 (“Sale of Goods”), wanted to have separate rules for business transactions and consumer transactions, as well as having business sales disputes decided by specialized “merchant courts.” The drafting committee rejected both those ideas. However, Llewellyn was able to write some sales law rules that reflected the power discrepancies often found in B2C transactions. In some areas, Article 2 provides added protections for consumers, and in other cases, it provides rules that only pertain to merchants. A merchant is defined in Section 2-104(1) as “a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.” Therefore, in some situations a person may be acting as a merchant, and in other situations, the person would be considered as a consumer.

UCC Consumer Rules

A number of “consumer rules are found in Article 2 of the UCC (sale of goods). The following shows two examples in the areas of the battle of forms and limitation of remedies. In the sale of goods, a common scenario is that a contract is formed through an exchange of forms, such as a price quotation (offer) followed by a purchase order (acceptance). This is referred to as the **battle of forms** scenario. The problem this scenario presents is that the two forms often conflict with the seller’s form having pro-seller standard terms and the buyer’s form having pro-buyer terms. The questions become: (1) can conflicting forms result in an enforceable contract? and (2) If a contract is formed, whose contract terms enter into the contract? Under UCC Section 2-207, an exchange of forms almost always forms a contract with the terms in the second form entering the contract. In contrast, a consumer must expressly agree to any additional or different terms in an exchange of forms situation.

Section 2-719 allows the seller of goods to limit its liability, including disclaiming liability for consequential damages. *Consequential damages*, otherwise known as special damages, are damages that are not directly related to a breach of contract or a breach of warranty, but, nonetheless, are caused by the goods. For example, if a seller sells a defective machine, then the direct damages would be the costs of repairing or replacing the machine. If the machine was intended to be resold by the buyer, then the buyer would be entitled to lost profits if the seller fails to deliver the machine or delivers a defective machine. If the machine is installed and malfunctions, causing injury to the buyer’s property or personal injury to the buyer’s employees, then these types of losses would be considered indirect or consequential damages because they do not relate directly to the sale of the machine. However, in consumer contracts under Section 2-719(3), such an exclusion would not be permitted: “Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable.” However, except for these few exceptions, there is no general law of consumer contracts or specialized rules in the common law of contracts to protect consumers when entering into contracts.

Restatement of Consumer Contract Law

There is a growing recognition that consumer contracts should be treated differently than business contracts. Mandatory rules protecting consumers are found in the new Consumer Financial Protection Bureau (regulation of consumer lending); FTC Fair Credit Practice Rule that prohibits cross-collateral clauses made famous by the seminal case on unconscionability (*Williams v. Walker-Thomas Furniture*); the Credit Card Accountability, Responsibility, and Disclosure Act (2009) requires credit card companies to allocate any payments first to the accounts with the highest interest rates; and Federal Trade Commission Act, Section 5 bans “unfair and deceptive acts and practices.”

The American Law Institute (ALI) recognizes consumer contracts as a specialized area of contract law and has begun work on a *Restatement (Third) of Consumer Contract Law*. The reporters for the project, Oren Bar-Gill and Omri Ben Shahr, have prepared a summary of the basic principles that currently or should govern consumer contract law. See Figure 11.10 *Focus on Transactions*: “Summary of Consumer Contract Issues.”

Problem: Quality of Consent

Issue: How can the law overcome the fact that consumers fail to understand the terms of their contracts?

Solutions:

Precontract Disclosure of Information: Standard method used in consumer protection law to deal with the lack of information provided to the consumer about the meaning of the contract.

Fraud and Deception: Seller disclosure of false or deceptive information.

Unknown Terms: Standard terms *should* only be enforceable if the consumer had the opportunity to access, read, and save the terms.

Problem: Substance of Contract Terms

Issue: *Modification of Contract:* Service providers often include a contract term that allows them to change the contract unilaterally.

Solution: The law *should* require that the provider obtain express consent from the consumer in order to make such changes.

Issue: *Termination Penalties:* Sellers in some consumer markets (mobile telephones) require long-term contracts (two years) and assess penalties if the consumer terminates the contract prematurely.

Solution: Some common law courts have viewed such terms as liquidated damages or determine whether they are illegal penalties.

Issue: *Forum Selection and Choice of Law:* Sellers often choose a forum (court) and law that make it difficult for a consumer to pursue a claim. UCC Section 1-301 limits the use of choice of law to avoid mandatory consumer protection laws of the consumer's home state. Some sellers use arbitration clauses but select a location for the arbitration that is inconvenient to most consumers. The Federal Arbitration Act protects the enforceability of these clauses, but some courts have used the doctrine of unconscionability to void such clauses.

Solution: The *doctrine of unconscionability* (voids overly one-sided contract terms or contracts) has been used primarily to protect consumers even through it technically also applies to commercial (B2B) contracts.

Interpretation of Consumer Contracts

Pro-Consumer Rules: (1) If a contract term is vague or ambiguous, it should be interpreted against the seller and in favor of the consumer (*contra proferentem* rule). (2) The *parol evidence rule* prevents the admission of evidence in contract disputes that would contradict the written contract. The rule should be "softened" to allow the admission of evidence of oral representations made by the seller to the consumer that contradicts the contract or seller's performance. (3) *Doctrine of good faith* should be used to regulate the seller's use of discretion that is granted under the contract.

Figure 11.10 Focus on Transactions: Summary of Consumer Contract Issues.

Chapter Summary

- 1 In negotiating with a foreign party, it is important to research the foreign country's cultural and negotiating norms. Some countries, like Japan and China, have different approaches to contract negotiations in that they take additional time to build up a relationship before undertaking the hard bargaining of negotiating the contract. It is also important to realize that decision-making may be done through consensus and that the person you are negotiating with may not have the power to agree to contract terms.
- 2 There are numerous sources of international contract law, but the applicable law will usually be the law of the country of one of the parties or a neutral country's law. Courts and especially arbitration tribunals often recognize customary international law (business usage and customs, as well as generally recognized principles) that can preempt the application of the legal rules of the applicable national law. The customs and usage of business or industries are referred to as the *lex mercatoria*. Two general principles of international law include *pacta sunt servanda* or the parties should honor their contracts, and courts should strictly enforce contracts, and the principle of *abus de droit*—unfair or unconscionable contracts, and clauses should not be enforced.
- 3 Sources of international contract law are also found in international legal instruments, such as the Convention on Contracts for the International Sale of Goods (CISG), UNIDROIT Principles of International Commercial Contracts (PICC), and publications of the International Chamber of Commerce (ICC), such as *INCOTERMS* (see Chapter 14) and the *UCP 600* (see Chapter 15).
- 4 There are some stark differences between different legal systems. For example, civil law enforces penalty clauses, while such clauses are unenforceable under the common law; the French Civil Code recognizes the doctrine of *arrhes* that relates to the retaining and refunding of deposits, while the common law has no such doctrine.
- 5 The formalities required to form a contract vary among legal systems. Also, different systems vary as to the enforceability of standard terms and standard form contracts or contracts of adhesion. The United States and United Kingdom generally enforce such terms, while such terms are highly regulated under German law and by EU law when one of the parties is a consumer.

- 6 Chinese Contract Law is interesting to study because it is a blend of rules taken from the civil law (mostly German law) and common law, as well as international instruments, such as the CISG and PICC.
- 7 The Principles of European Contract Law (PECL) provide a comprehensive set of contract law rules. The PECL is not a mandatory law but can be used by countries reforming their national laws and can be used in drafting contracts.
- 8 The PICC is a well-established model law that can be used for all types of contracts, as compared to the CISG, which only covers sale of goods transactions.
- 9 A major difference between the civil and common laws is in the area of precontractual liability. The civil law recognizes the duty to negotiate in good faith; the common law does not. The civil law recognizes the tort of *culpa in contrahendo* (bad faith negotiations), which allows a party to sue for damages against a party breaking off negotiations. If the negotiations were long-term and the parties had agreed on the material terms, then a party may sue for full contract damages (lost profits) against the party breaking off negotiations. The closest the common law gets to precontractual liability is the doctrine of promissory estoppel, where a party may sue for out of pocket expenses (reliance damages) if it had reasonably relied on the promise or assurance of another party and an injustice would be done unless the court provides some remedy.
- 10 Precontractual instruments, such as letters of intent or comfort letters, are generally not enforceable, although they are more likely to lead to liability in some civil law countries.
- 11 Consumer contracts are treated differently in the European Union, where there is a separate consumer contract law, while the American Uniform Commercial Code applies equally to commercial and consumer sales transactions.

Key Terms

<i>Abus de Droit</i>	European Union Directive on	Open Terms
Acceptance	Unfair Terms	Offer
<i>Acquis</i> or <i>Acquis</i>	Firm Offer Rule	<i>Pacta Sunt Servanda</i>
<i>Communautaire</i>	French Civil Code	Penal (Penalty) Clause
Agency	Genuineness of Assent	Perfect Tender Rule
Battle of Forms	German Civil Code	Precontractual Liability
Breach of Confidentiality	Hardship	Price Reduction (Remedy)
Chinese Contract	Impediment	Principles of European Contract
Law (CCL)	Implied Warranty for a Particular	Law (PECL)
Comfort Instruments	Purpose	Promissory Estoppel
Consumer Contract Law	Implied Warranty of	Restatement (Second) of
Consumer Law <i>Acquis</i>	Merchantability	Contracts
Contract of Adhesion	INCOTERMS	Russian Civil Code
Convention on Contracts for the	Indirect Representation	<i>Shari'a</i> Law
International Sale of Goods	International Chamber of	Specific Performance
(CISG)	Commerce (ICC)	Standard Terms
Council of Europe	International Institute for the	Statute of Frauds
<i>Culpa in Contrahendo</i>	Unification of Private Law	Totality of the Circumstances
Customary International	(UNIDROIT)	Analysis
Business Law	<i>Lex Mercatoria</i>	UNIDROIT Principles of
Direct Representation	Liquidated Damage Clause	International Commercial
Doctrine of <i>Arrhes</i>	Mailbox Rule	Contracts (PICC)
Doctrine of Unconscionability	Merger Clause	Uniform Commercial Code
Economic Duress	<i>Nachfrist</i> Notice	(UCC)
English Unfair Contract Terms	Notice	<i>Wa</i> (harmony)
Act of 1977	<i>Obligations de Faire</i>	Written Modification Clause

Chapter Problems

- 1 Justice Cardozo noted a profound change in the law of contracts and the reduced role of formality as a requirement for contractual liability in the following quote: “The law has outgrown its primitive stage of formalism when the precise word was the sovereign talisman, and every slip was fatal. It takes a broader view today. A promise may be lacking, and yet the whole writing may be *instinct with an obligation*, imperfectly expressed.” *Wood v. Duff-Gordon*, 222 N.Y. 88 (1917). If this is true, what are the consequences for precontractual liability? Do contracts have to be very detailed in order to be enforceable?
- 2 Two firms work together to prepare a complex bid for a buyer. One firm (Company A) dropped the other (Company B) before getting the bid. After working for some time on specifications, negotiating with the buyer, and being chosen as a final candidate for the job, Company A told Company B that it was disappointed with Company B’s behavior and obtained the contract on its own, with minor modifications from the joint proposal submitted previously. Company B sued Company A for breach after Company A subcontracted the work to another firm. Since there was no formal subcontract, what theory of recovery can Company B allege? What types of damages, if any, may Company B claim? *TACS Corp. v. Trans World Communications, Inc.*, 155 F. 3d 659 (3rd Cir. 1998).
- 3 Review the *Bojangles*, *Plas*, *Grifoni*, and *SA Pasquasy* cases on preliminary agreements and *culpa in contrahendo* and answer the following questions. What could the party being sued have done differently to avoid liability? Would your answer be different under U.S. law as compared to civil law?

Internet Exercises

- 1 Review Schedule 2 (“Consumer contract terms which may be regarded as unfair”) of the Consumer Rights Act of 2015 to see which terms are considered unfair and enforceable when placed in consumer contracts. You can find Schedule 2 at <http://www.legislation.gov.uk/ukpga/2015/15/schedule/2/enacted>. Merchants often place exculpatory clauses (limits liability of merchants for harm caused by merchant’s negligence) in their contracts. Are such terms enforceable under the 2015 Act? See Terms 1 and 2 on Schedule 2. What if the contract had an arbitration clause, where exculpatory clauses are generally enforced? See Term 20(a).
- 2 Review the European Commission’s home page for Consumer Affairs at http://europa.eu/pol/cons/index_en.htm. What types of consumer protection initiatives has the EU undertaken? What areas in the subject index would be a concern for an international businessperson?
- 3 Read the “overview” of the Council of Europe, along with the different subject areas within the organization, and associated links: www.coe.int/en/web/portal/home.
- 4 Review the subjects covered in Principles of European Contract Law Part III, which were added in 2002 (Chapters 10–17) at www.jus.uio.no/lm/eu.contract.principles.parts.1.to.3.2002.

Other Internet Sources

International Trade Administration—Information on foreign culture and customs: <http://trade.gov>.

For links to **modern *lex mercatoria***: www.jus.uio.no/lm.

UNIDROIT—menu of sponsored conventions: www.unidroit.org.

United Kingdom Department of Trade and Industry—**English unfair terms in consumer contracts regulations**: www.gov.uk (search “unfair terms”).

Council of Europe: www.coe.int.

Principles of European Contract Law: www.jus.uio.no/lm/eu.contract.principles.parts.1.to.3.2002 or www.ufsia.ac.be/~estorme/PECL2en.html.

Notes

- 1 Claude Cellich, "Review of *Cross-Cultural Business Negotiations* by Donald W. Hendon, Rebecca A. Hendon, and Paula Herbig," 10 *Journal of International Consumer Marketing* 120 (1998).
- 2 Magoroh Maruyama, "Contracts in Cultures," 10 *Human Systems Management* 33 (1991).
- 3 Veronica L. Taylor, "Continuing Transactions and Persistent Myths: Contracts in Contemporary Japan," 19 *Melbourne University Law Review* 352, 353, 356, 364, 393, 395 (1993).
- 4 Comment, "'Working it Out': A Japanese Alternative to Fighting it Out," 37 *Cleveland St. Law Review* 149, 157 (1989).
- 5 Ole Lando, "The *Lex Mercatoria* in International Commercial Arbitration," 34 *International and Comparative Law Quarterly* 747 (1985).
- 6 See CISG Articles 47–48, 63. See Chapter 12.
- 7 International Chamber of Commerce, *The UNIDROIT Principles for International Commercial Contracts: A New Lex Mercatoria?* (1995).
- 8 Restatement (Second) of Contracts at § 19, Comment *b*.
- 9 See Larry A. DiMatteo, "The Counterpoise of Contracts: The Reasonable Person Standard and the Subjectivity of Judgment," 48 *South Carolina Law Review* 293, 318 (1997).
- 10 Restatement (Second) of Contracts at § 221, Comment *b*.
- 11 Unfair Contract Terms Act § 4(1) (1977).
- 12 22 Tenn. 493, 514–515 (1842).
- 13 Nabil Saleh, "The Law Governing Contracts in Arabia," 38 *International and Comparative Law Quarterly* 761, 763 (1989).
- 14 See UCC § 2-718.
- 15 9 Exch. 341, 156 Eng. Rep. 145 (1854).
- 16 See Article 4.110(2)(b) (Unfair Terms Not Individually Negotiated).
- 17 European Principles at Article 2.205 (Time of Conclusion of the Contract).
- 18 European Principles at Article 2.202 (Revocation of an Offer).
- 19 European Principles at Article 2.207(2) (Late Acceptance).
- 20 Compare UCC § 2-207 and CISG Article 19.
- 21 European Principles at Article 2.301 (Negotiations Contrary to Good Faith).
- 22 European Principles at Article 3.203 (Unidentified Principal).
- 23 European Principles at Article 3.208 (Third Party's Right with Respect to Confirmation of Authority).
- 24 European Principles at Article 4.103 (Mistake as to Facts or Law).
- 25 European Principles at Article 4.105(3) (Adaptation of Contract).
- 26 European Principles at Article 4.107 (Fraud).
- 27 European Principles at Article 4.108 (Threats).
- 28 European Principles at Article 4.109 (Excessive Benefit or Unfair Advantage).
- 29 European Principles at Article 4.110 (Unfair Terms which have not been Individually Negotiated).
- 30 European Principles at Article 8.108 (Excuse Due to an Impediment). Compare UCC § 2-615 (Impracticability) and CISG Article 74.
- 31 UCC § 2-601 (Perfect Tender Rule).
- 32 See CISG Article 50 (Chapter 12).
- 33 UCC § 2-716 (Buyer's Right to Specific Performance).
- 34 Michael J. Bonell, "Non-Legislative Means of Harmonization" in *Uniform Commercial Law in the Twenty-First Century*, 38 (United Nations, 1995).
- 35 Article 1.2. Compare UCC §§ 2-201 and 2-202.
- 36 Article 1.8. Compare UCC § 1-205.
- 37 Hans van Houtte, "The UNIDROIT Principles of International Commercial Contracts," 11 *Arbitration International* 373, 374–378 (1995).
- 38 Article 6.2.2. Compare UCC § 2-615.
- 39 1999 WL 683006 (DC Cir.).
- 40 729 S.W.2d 768 (Tex. Ct. App. 1987).
- 41 See Michael Tegethoff, "*Culpa in Contrahendo* in German and Dutch Law—A Comparison of Precontractual Liability," 5 *Maastricht Journal of European and Comparative Law* 341, 347 (1998).
- 42 See generally Larry A. DiMatteo and Rene Sacasas, "Credit and Value Comfort Instruments," 47 *Baylor Law Review* 357 (1995).
- 43 1924 All E.R. 245, 255 (Ct. App. 1923).
- 44 LEXIS Enggen library, Cases file (QB July 19, 1985).
- 45 See UCC §§ 2-718 (liquidated damages; limitation of damages) and 2-719 (limitation of remedy).

INTERNATIONAL SALES LAW

The success of **international customary law** or trade usage provided a strong foundation for an international convention on sales law. Examples of the expansion of international customary law in the area of commercial transactions include the universal acceptance of the International Chamber of Commerce's INCOTERMS (glossary of trade terms) and its regulations relating to international letters of credit (Uniform Customs and Practices for Documentary Credits or UCP). The major area lacking uniformity was the law covering the underlying transaction—the sales contract. The **United Nations Convention on Contracts for the International Sale of Goods (CISG)** is the most successful attempt to fill in this gap; it promises to become the foundation for a uniform international law of sales for the twenty-first century.

This chapter will review the CISG in detail in order to expose the reader to this important international document and to review the major issues of international sales law. The CISG will be compared to the U.S. **Uniform Commercial Code (UCC)** and differences will be highlighted. These differences are most likely to result in unexpected legal liability for the U.S. businessperson. An in-depth review serves two major purposes: it familiarizes the reader with major sales law issues common to all legal systems and allows for a closer analysis of how these issues are treated differently among nations. It is prudent to refer to the actual provisions of the CISG found in the Appendix to this book when reading this chapter

International Sales Law

Most legal issues in international trade are settled by application of national laws. At the beginning of the twenty-first century, however, we can begin to discuss the evolution of a truly international law of sales or a new *lex mercatoria*. *Lex mercatoria* or law of merchants refers to a system of rules of law created by international merchants, independent of any national legal system, for the purpose of governing international business transactions. The adoption in 1980 of the CISG marked a milestone in the development of the new *lex mercatoria*. The CISG went into effect in the United States on January 1, 1988. Thus, the United States has two laws of contracts for the sale of goods: the UCC and the CISG. In a case where two contracting parties are residents of the U.S. and another CISG country, a U.S. court will apply the CISG rather than the UCC. The CISG, however, is an optional law and the parties may *opt out* of it through a choice of law clause in their contract. At the current rate of adoption, there will be more than one hundred member countries in the near future. The list of the contracting states includes most of the U.S.' major trading partners including Australia, Brazil, China, Canada, France, Germany, Italy, Mexico, Russia, Spain, and the Nordic countries (Denmark, Finland, Norway, Sweden). Countries that have not adopted the CISG include India and the United Kingdom.

The coverage of the CISG can be grouped into three broad areas: substantive coverage, **jurisdiction**, and types of transactions. The CISG covers most substantive issues of contract law. There are, however, areas of contract law not covered under the CISG, including products liability, the legality of a contract, the capacity of the parties to contract, and whether the non-breaching party is entitled to specific performance. These substantive areas would be decided under a national law of contract. The national law to be applied would be determined by applying the courts' **conflict of law rules** (see Chapters 1 and 4).

Scope of the CISG

Article 1 of the CISG provides the two core principles upon which CISG jurisdiction is determined: internationality (countries of the contracting parties) and the type of transaction (sale of goods). The first principle is divided into two types of jurisdiction—one where the two parties are from different CISG countries (Article 1(1)(a)) and the other where only one of the parties is from a CISG country (Article 1(1)(b)). Under the second type, the CISG applies as follows: When the sale of goods is between parties in which only one of the parties is from a CISG country, the court or arbitral tribunal is instructed to use its conflict of law rules to determine the law of the dispute. If the conflict of law rules direct the court or tribunal to the party whose country has ratified the CISG, then the CISG becomes the law of the dispute. However, the U.S. was one of the few countries that opted out of Article 1(1)(b) jurisdiction, meaning in U.S. courts the CISG is only applicable when both parties are from CISG countries. An additional method for CISG jurisdiction is its use in a choice of law clause in a contract that “opts in” by selecting the CISG as applicable law even if both parties are not from CISG countries.

It is important to know that in determining the country of a party for CISG jurisdictional purposes, where the company is incorporated or where it has its principal **place of business** (headquarters) is not the determining factor. Article 10 states that: “the place of business is that which has the closest relationship to the contract and its performance.” Therefore, in the case of two American companies, both incorporated in the State of Delaware, the court in *Asante Technologies v. PMC-Sierra*,¹ held that the CISG applied since the deal was negotiated by one of the companies’ Canadian offices for performance in Canada. Since Canada and the U.S. are both members of the CISG, the CISG was the applicable law (even though both companies were legally U.S. companies).

The second principle is based on how “goods” are defined for purposes of the CISG. The CISG does not apply to: (1) consumer sales (goods purchased for personal, family, or household use); goods sold by auction; sales of ships, vessels or aircraft; sales by execution of law (lien foreclosure); or the sale of electricity; (2) goods that were produced in which a preponderant part of the “seller’s” obligations is to provide services or labor, or when the “buyer” supplies a substantial amount of materials used in producing the good; and (3) the CISG does not cover numerous areas related to the sale of goods such as liability for personal injury or products liability (tort law), the availability of the remedy of specific performance, and validity of contracts.

The area of validity of contracts covers two areas including, (1) doctrines in the law that challenge the genuineness of consent of one or both of the parties in entering the contract and (2) specific clauses in the contract that are considered illegal or unenforceable under national law. In the first case, the legal consent of the parties is challenged using a number of consent-canceling doctrines, such as mistake, duress, undue influence, and misrepresentation or fraud. In the second case, specific contract clauses are deemed illegal or against public policy in some countries. For example, under the U.S. common law and government statutes, penalty clauses, interest clauses that charge a usurious rate of interest, and clauses deemed to be unconscionable are unenforceable.

Finally, the CISG covers only certain areas of contract law, such as contract formation, performance, breach, and the remedies available for breach of contract. In other areas not within the scope of the CISG the answers are to be found in the applicable domestic (national) law determined by a choice of law clause or by conflict of law rules, which will be discussed in the next section.

Choice of Law and Conflict of Law

A **choice of law clause** used to avoid application of the CISG must be carefully drafted. For example, the parties may intend the UCC to be the law of the transaction. To that end the parties negotiate the following choice of law clause: “the law of the State of New York shall apply to any disputes.” Under Article 1(1)(a) of the CISG, however, the law of New York is the CISG if the two parties are from different CISG countries. In order to avoid such a quagmire, clear choice of law clauses should be drafted. For example, the above choice of law clause should specify that the “Uniform Commercial Code of the State of New York” is the applicable law.

Another ground for the use of the CISG in a dispute is based in customary international law. An arbitral panel or a court may use the CISG as evidence of trade usage in place of applying the law of an individual country.

This is exactly what happened in *International Chamber of Commerce Arbitration Case No. 5713 of 1989*. In that case, the contract contained no provisions regarding the substantive law (no choice of law clause). Therefore, the arbitrators applied the law designated as the proper law by applying conflict of law rules that they deemed appropriate. The law of the country of the seller appeared to be the proper law governing the contract. Instead, the tribunal found that there is no better source to determine the prevailing trade usage than the terms of the CISG. This was so even though neither the country of the buyer or the country of the seller had adopted the CISG. The issue in the case was the length of time a purchaser had to give notice of defect. The arbitration tribunal disregarded the domestic law's shorter statute of limitations period in favor of the two-year period provided in the CISG. In short, the arbitral tribunal used the CISG as evidence of international trade usage to avoid what it deemed to be an unfair domestic law. The arbitrator's decision stated that "as the applicable provisions of the law of the country where the seller had his place of business appeared to deviate from the generally accepted trade usage as reflected in the CISG in that it imposed extremely short and specific requirements in respect of the buyer giving notice to the seller in case of defects, the tribunal elects to apply the CISG."

This voluntary application of the CISG as evidence of customary international law in the above ICC case should not come as a surprise. The CISG is the product of compromise between the world's major legal systems—common law, civil law, and socialist law. Thus, it possesses a universal appeal that many arbitrators will find appealing in their search for a *lex mercatoria*—type of justification for their awards. The terse, clear, and nonlegal language of the CISG provides arbitrators a good source of supranational rules of commerce.²

Commercial Sale of Goods

The CISG covers only transactions for the sale of goods. Thus, sales of services and transfers of intellectual property rights would not come under the jurisdiction of the CISG. There are many transactions, however, that include more than one subject matter. For example, the sale of computer software is often a **mixed sale** involving the sale of a tangible item, like a disc or a CD-ROM, along with a service or technical assistance agreement, and a license pertaining to intellectual property rights. Is this type of transaction covered by the CISG? Article 3 provides a two-part test to distinguish a service contract from a sale of goods. First, a contract is not for the sale of goods if the buyer provides a substantial part of the materials used in the production of the goods. This would be considered a contract for labor or assembly services. Second, a preponderant part of the contract is for the supply of labor or services.

In *Micro Data Systems, Inc. v. Dharma Systems*,³ the court held that labor can be considered as a component part of a good when determining the applicability of the UCC to a mixed sale transaction. In that case, the buyer agreed to pay \$125,000 for software and \$125,000 for services necessary to adapt the system to the buyer's needs. The court ruled that the "services" were not services to be rendered directly to the buyer, but merely the labor to be extended in producing the modified software.

A **computer software sale** normally mixes the characteristics of a sale of goods, a sale of services, and a lease or license of technology, since software possesses both tangible and intangible elements. According to Article 3's second test a software sale will be considered within the scope of the CISG only if a preponderant part of the transaction is for tangible goods. If, for example, a company contracts for software to computerize its inventory the court may look to the allocation of the price within the contract among the different components. Thus, if the contract provided for \$20,000 worth of database software and \$15,000 worth of support service and labor for data entry, the contract would be considered predominantly one for the sale of goods and covered by the CISG.

One suggested resolution for the intangibility of technology and software is to treat such items as **virtual goods**,⁴ the approach taken in applying the UCC to software products. Virtual goods are treated just like conventional goods for purposes of UCC and possibly CISG applications. Article 2 of the UCC covers "transactions in goods." Thus, its coverage is limited not to sales but by the word *transactions*. In contrast, the CISG expressly uses the term "sales" when defining its coverage. Its definition of goods is based primarily upon the concept of *movability*. Software clearly satisfies the requirement of movability.

The crucial determination of CISG applicability is if the sale of a copy of software, along with a license for its use, is considered a transaction in “goods.” Generally, items sold by way of license are considered not to be sale of goods. Software licensing agreements, however, often have the characteristics of sale of goods transactions. If the copy being licensed is one for perpetual use for which the licensee pays a one-time licensing fee, then the software is essentially being sold even though the “license” retains title in the name of the licensor. In short, even though ownership over the technology is retained by the licensor, the licensee becomes the owner of the copy. Thus, the CISG is likely to cover sales of “off the shelf” software.

Parol Evidence Rule and CISG

The UCC requires that “some writing sufficient to indicate that a contract of sale has been made” must evidence any sale of goods for a price of \$500 or more. Also, the party against whom enforcement is sought must have signed the writing. In contrast, the CISG applies the view of many civil law countries that a written contract is not required in order to enforce an agreement. By its adoption of the common law’s **parol evidence rule**, the UCC writing requirement or **statute of frauds** also prevents the admission of evidence that contradicts the writing. The parol evidence rule protects the sanctity of a written contract intended to be the final agreement or integration of agreements of the parties. The rule prevents admitting into evidence any prior or contemporaneous oral statements or writings that contradict the contract.

Along with stating the requirements for a legally sufficient writing, UCC Section 2-201 lists a number of exceptions, including the **written confirmation rule**, an order for **specially manufactured goods**, and where the parties’ conduct has overtaken the lack of a sufficient writing such as when payment or receipt of goods occurs. The written confirmation rule is available only in commercial transactions since it requires that both parties be merchants. It states that a writing sent by one of the parties confirming the conclusion of a contract is sufficient to satisfy the writing requirement. The other party need not sign or acknowledge receipt of the confirmation in order to be bound by it. Section 2-201 does allow the receiving party to object to the confirmation and thus prevent the formation of a contract. The notice of objection must be given within ten days of the receipt of the written confirmation. The court in *GPL Treatment, Ltd. v. Louisiana-Pacific*⁵ analyzed the intricacies of the written confirmation rule.

GPL Treatment, Ltd. v. Louisiana-Pacific

914 P.2d 682 (Or. Sup. Ct. 1996)

This case involves the so-called merchant’s exception to the statute of frauds in the Uniform Commercial Code. Plaintiff (GPL) sued defendant (Louisiana-Pacific) for breach of an oral contract to buy 88 truckloads of cedar shakes. Louisiana-Pacific denied the alleged contract and asserted the UCC statute of frauds as an affirmative defense. The relevant text of GPL’s form that was entitled “ORDER CONFIRMATION” reads as follows:

“Conditions of Sale:”

All orders accepted subject to strikes, labor troubles, car shortages, or other contingencies beyond our power. Any freight rate increases, sales, or use taxes is for buyer’s account.

GPL LTD.

BY: _____

“SIGN CONFIRMATION COPY & RETURN”

BY: _____

Thereafter, the price of cedar shakes dropped and defendant’s needs changed. The defendant refused to place orders for more than 13 truckloads. Plaintiff brought a breach of contract action for lost profits.

Van Hoomissen, Justice. Under the written confirmation exception to the statute of frauds, the writing in confirmation of the [oral] contract must be signed by the sender, state a quantity, and evidence a contract for a sale

of goods. A written confirmation sent pursuant to the merchant's exception need not contain all material terms of the contract; it must simply confirm a contract and include a quantity term. A merchant who receives a confirmatory writing may escape being bound only by giving a written objection within ten days. A determination that a writing satisfies the merchant's exception does not prove the existence of a contract, however. It merely prevents the party against whom enforcement is sought from raising the UCC statute of frauds as an affirmative defense.

The defendant raises the issue that the "Sign Confirmation Copy and Return" language on the confirmation required the defendant to sign before a binding contract was to be formed. There is no single correct answer to the question of the effect of a "sign and return" clause. Each writing must be examined independently and in light of its own contents and context. Considering GPL's writing in its entirety, we conclude that notwithstanding the "sign and return" clause, GPL's order confirmation forms are sufficient to satisfy the merchant's exception.

The order confirmation forms that the seller sent to buyer constituted a writing in confirmation of an alleged oral contract and sufficient against the sender and, thus, the forms satisfied the merchant's exception to the Uniform Commercial Code's statute of frauds, despite the fact that the forms contained a "sign and return" clause.

Graber, Justice, dissenting. The majority holds that the document does not require the recipient to sign the confirmation copy and return it. It reads the "sign and return" language to be nothing more than a request to acknowledge receipt of the form. The majority's reasoning is flawed. A true confirmation requires no response. Here, the document required the prospective buyer to sign and return a copy, thus reducing the document to the status of an offer that would take effect if and when it was "Accepted By" the buyer. In summary, because the document at issue required a response, it did not constitute a "writing in confirmation" of a prior oral agreement as required by the merchant's exception in the Uniform Commercial Code.

Case Highlights

- The statute of frauds is an affirmative defense that must be raised and proved by the defendant.
- The written confirmation exception to the statute of frauds provides that a written instrument (letter, fax, or e-mail) sent by one merchant to another merchant satisfies the writing requirement unless the other merchant objects within ten days.
- A sign and return clause may or may not convert a written confirmation into a mere offer.

The parol evidence rule seeks to preserve the integrity of written contracts by refusing to allow the admission of oral statements or previous correspondence to contradict the written agreement. Under this rule, when parties place their agreement in writing, all previous oral and written communications merge into the final written agreement. However, such final written agreements may be explained or supplemented by prior dealings, trade usage, or course of performance information. **Prior dealings** include prior contracts and performances under prior contracts between the parties that establish a common basis of understanding for interpreting subsequent contracts. **Trade usage** refers to the customs and practices regularly observed in a given trade or business. Trade usage refers to the customs and practices regularly observed in a given trade or business. Usages of trade is the background meaning of words and terms developed by merchants in that trade. A person in a trade or business is presumed to know the usages and meanings used in that trade or business: "When the usage consists of a system of rules, the parties need not be aware of a particular rule if they know or have reason to know the system and the particular rule is within that system" (Source: *Restatement (Second) of Contracts* § 222, Comment b.). **Course of performance** is premised on the fact that the parties' conduct in performing under the contract is a good indication of what they believe to be its meaning. Section 2-208 of the UCC states that "any course of performance accepted or acquiesced in without objection shall be relevant to determine the meaning of the agreement."

Unlike the UCC, the CISG in its Article 11 states that a "contract need not be evidenced by writing." Also, a contract and its terms may be proven "by any means," including witness testimony. Therefore, the potential for liability for representations made during the negotiation stage is greater under the CISG. The UCC's parol evidence rule allows a party to avoid liability for statements made during the negotiations if those statements are not placed within the final written contract. Under the CISG, prior oral statements regarding anything, including quality and performance, are potentially enforceable. The CISG's lack of a writing requirement and of a parol evidence rule

gives the recipient of a letter or documents a strategic advantage in proving enforceability. Also, oral assurances given to persuade another party to enter into a contract may be used to prove intent.

Articles 12 and 96, which allow contracting states to opt out of Article 11's no writing requirement, further complicate the CISG's lack of a writing requirement. Some countries, mostly the former countries of the Soviet Union and socialist law countries, have opted out in favor of domestic laws that require a written document. These countries include Russia, Ukraine, Belarus, Estonia, Hungary, Argentina, and Chile.

The importance of the parol evidence rule to contract disputes is discussed in *MCC-Marble Ceramic Center v. Ceramica Nuova D'Agostino*. This is the most recent U.S. case involving the interaction of the CISG with other U.S. laws. The court is asked to determine if the U.S. parol evidence rule is to be applied to cases involving the CISG.

MCC-Marble Ceramic Center v. Ceramica Nuova D'Agostino

144 F. 3d 1384 (11th Cir. 1998)

"MCC" is a Florida corporation engaged in the retail sales of imported tiles. "D'Agostino" is an Italian manufacturer of tiles. At a trade show they orally agreed on a sale of tiles. The agreed terms were placed on one of D'Agostino's standard preprinted order forms. The executed forms were printed in Italian. MCC brought suit claiming a breach of the requirements contract when D'Agostino failed to satisfy a number of orders. D'Agostino responded that it was under no legal obligation to fill the orders because MCC had defaulted on payment for previous shipments. MCC responded that the earlier tiles they received were of a lower quality than contracted for and that it was entitled to reduce payment in proportion to the defects. D'Agostino replied that Clause 4 on the reverse side of the purchase order form required that all complaints for defects must be made in writing not later than ten days after receipt of merchandise and this had not been done by MCC. MCC argued that the parties never intended the terms and conditions printed on the reverse of the order form to apply to their agreement.

Birch, Circuit Judge. Article 8 of the CISG provides: "For purposes of this Convention statements made by and other conduct of a party are to be interpreted according to his intent where the other party knew or should have been aware what that intent was. Due consideration is to be given to *all* relevant circumstances of the case including negotiations." The plain language of the Convention, therefore, requires an inquiry into a party's subjective intent as long as the other party to the contract was aware of that intent. MCC argues that it did not intend to be bound by the terms on the manufacturer's form since it was entirely in Italian. We find it nothing short of astounding that an individual, purportedly experienced in commercial matters, would sign a contract in a foreign language and expect not to be

bound simply because he could not comprehend its terms. The general proposition is that standard terms will bind parties who sign contracts regardless of whether they have read them or understand them. Nonetheless, Article 8(1) of the CISG requires a court to consider evidence of the parties' subjective intent. Affidavits of agents of MCC acknowledged that D'Agostino's representatives were aware of MCC's subjective intent not to be bound by the fine print terms.

The issue of whether the parol evidence rule applies to the CISG is a question of first impression in this circuit. It is important to whether the testimony of MCC's subjective intent and D'Agostino's awareness of it will be admitted to contradict or vary the terms of the written contract. We begin by observing that the parol evidence rule, contrary to its title, is a substantive rule of law, not a rule of evidence. The Uniform Commercial Code includes a version of the parol evidence rule that states that "a writing intended by the parties as a final expression of their agreement may not be contradicted by evidence of any prior agreement or contemporaneous oral agreement." The CISG contains no express statement on the role of parol evidence. Moreover, Article 8(3) of the CISG expressly directs the courts to give "due consideration to all relevant circumstances of the case including the negotiations." It is a clear instruction to admit and consider parol evidence regarding the negotiations to the extent they reveal the parties' subjective intents.

Another court, however, appears to have arrived at a contrary conclusion. In *Beijing Metals & Minerals Import/Export Corp. v. American Bus. Ctr., Inc.*,⁶ a defendant sought to avoid summary judgment on a contract claim by relying on evidence of negotiated oral terms that the parties did not include in their written agreement. The court held that the parol evidence rule would apply

regardless of whether Texas law or the CISG governed the dispute. We find the Beijing opinion is not particularly persuasive on this point. Moreover, the parties in the present case have not cited to us any persuasive authority from the courts of other States party to the CISG.

Our reading of Article 8(3) as a rejection of the parol evidence rule, however, is in accordance with the great weight of academic authority. Furthermore, a wide number of the other States that are parties to the CISG have rejected the rule in their domestic jurisdictions. One of the primary factors motivating the negotiation and adoption of the CISG was to provide parties to international contracts for the sale of goods with some degree of certainty as to the principles of law that would govern potential disputes. Courts applying the CISG cannot, therefore, upset the parties' reliance on the Convention by substituting familiar principles of domestic law such as the parol evidence rule when the Convention requires a different result. Moreover, to the extent parties wish to avoid parol evidence problems they can do so by including a **merger clause** in their agreement that extinguishes any and all prior agreements and understandings not expressed in the writing.

What a judge or jury does with the parol evidence once it is entered into evidence is within their discretion as they are entrusted to weigh the evidence. A reasonable finder of fact is free to disregard the parol evidence that conflicts with the written contract. Thus, it may disregard testimony that sophisticated international merchants signed a contract without intending to be bound as simply too incredible to believe and hold MCC to the conditions printed on the reverse side of the contract. However, this is for the trier of fact to determine. Moreover, because Article 8 requires a

court to consider any "practices which the parties have established between themselves, usage, and any subsequent conduct of the parties" in interpreting contracts, whether the parties intended to adhere to the ten day limit for complaints of defects, as stated on the reverse of the contract, will have an impact on whether MCC was bound to adhere to the limit in order to preserve its warranty claims.

The CISG precludes the application of the parol evidence rule, which would otherwise bar the consideration of evidence concerning a prior or contemporaneously negotiated oral agreement. Since material issues of fact remain, we cannot affirm the district court's summary judgment in D'Agostino's favor.

Case Highlights

- The court suggests that the use of a merger clause would be an effective means to prevent parol evidence from being admitted. A merger clause is a statement that the final written contract is conclusive evidence of the parties' agreement.
- Since the CISG has been adopted in numerous countries, any previous foreign decisions on a particular issue should be reviewed in order to obtain uniform interpretations of the CISG.
- The CISG provides a price reduction in its Article 50 as a remedy for the delivery of nonconforming goods.
- The two-year period found in Article 39 of the CISG is the outside limit for giving a notice of defect. A party must give notice within a reasonable time, which will normally mean within days of finding the defect. In addition, the parties can agree to a shorter notice period.

CISG and Uniform Commercial Code

This section will focus on the substantive provisions of the CISG in order to instruct as to the potential for unintended legal liability in international contracting. These substantive provisions will be compared to relevant provisions in the UCC (see Table 12.1 *Comparative Law*: "Comparison of CISG and UCC"). Although the UCC acted as a blueprint for the drafting of the CISG, the U.S. exporter must be cognizant of the fundamental differences between the two laws. It is important that the CISG be understood and applied effectively by U.S. exporters and importers. It not only places some unique responsibilities on sellers and buyers of goods, it also provides a number of rights and remedies not found in U.S. law.

Contract Formation: Offer–Acceptance Rules

The CISG can be divided into four groups: General Provisions (Articles 1–13), **Contract Formation** (Articles 14–24), Rights and Obligations (Articles 25–88), and **Ratification** (Articles 89–101). This section will examine

Table 12.1 *Comparative Law: Comparison of CISG and UCC*

<i>Description of Topic</i>	<i>CISG Article</i>	<i>UCC Section</i>
Writing Requirement	11, 13, and 14	2-201
Parol Evidence Rule	8 and 9	2-202
Contract Formation	14, 19–21, and 23	2-204
Obligation of Good Faith	Implied	1-202
Revocability of Offer (Firm Offer Rule)	16	2-205
Time of Acceptance	18	2-206
Battle of Forms	14 and 19	2-207
Fixing Price Term	14, 55, and 56	2-305
Place of Delivery	57	2-308
Time of Delivery	33, 47, 48, and 63	2-309
Place of Payment/Time for Payment	57	2-310
Avoidance (Termination) & Manner of Rejection	81 and 86	2-602
Right to Reject Goods	25 and 49	2-601
Warranty of Title	41 and 42	2-312
Express and Implied Warranties	35	2-313 to 2-316
Duty and Right to Inspection	38	2-513
Nonconformity; Nondelivery	36, 49, and 51	2-601
Notice of Nonconformity	39	2-607(3)(a)
Fundamental Breach; Notice	25 and 49	2-608
Anticipatory Breach (Repudiation)	71–73	2-609 and 610
Price Reduction Remedy	50	None
<i>Nachfrist</i> Notice	47, 48, and 63	None
Excuse or Exemption from Liability	79	2-615
Notice of Excuse	27	2-616

the group dealing with Contract Formation, along with articles in the Ratification group that bear on formation. All legal systems recognize the formation of a contract when an **offer** and **acceptance** are exchanged. The key issue is determining the exact time of formation. This determination is important in order to decide the effectiveness of attempted **revocations** by the **offeror** and attempted **rejections** (subsequent to the sending of an acceptance) by the **offeree**. The offeror is the party making an offer to contract. The offeree is the party that receives an offer and is empowered to create a binding contract through an acceptance of the offer. Sometimes a contract is considered formed when the offeror invites the offeree to accept by the commencing of performance and performance begins. Commencement of performance may not be sufficient, however. Most legal systems require the offeree to notify the offeror within a reasonable time that performance has commenced. Section 2-206 (2) of the UCC states that “where the beginning of a requested performance is a reasonable mode of acceptance an offeror who is not notified of acceptance within a reasonable time may treat the offer as having lapsed before acceptance.”

The common law rule known as the dispatch or **mailbox rule** holds that a contract is formed upon the sending of the acceptance by placing it into a reasonable means of transmission. All other legal systems of the world, and the CISG, find a contract only when and if the acceptance or notice of the acceptance is received by the original offeror. Article 1326 of the Italian Civil Code states that an acceptance must be communicated to the offeror within the term that is deemed reasonable according to the nature of the business or trade customs.

Most international commercial transactions involve long-term negotiations, along with numerous exchanges of correspondences and documents. It is often the difficult task of a court or arbitral tribunal to analyze the numerous exchanges to determine if and when a contract was formed. Articles 14–24 of the CISG, similar to those found in U.S. law, outline a number of offer–acceptance rules to be used to resolve formation issues. The following Hungarian court decision, *Pratt & Whitney Corp. v. Malev Hungarian Airlines*, was one of the first to apply these rules.



Image 12.1 Ancient Sales Contract (Louvre).

Source: Stone Sales Contract, Wikimedia Commons.

Not all contracts are formed through the exchange of promises: “I offer to sell” followed by an “I accept” (**bilateral contracts**). Contracts may also be formed by a promise followed by conduct or performance (**unilateral contracts**). An offer may invite an acceptance by performance and not require a return promise of acceptance. For example, the offer may state “send goods immediately.” In such a case, the sending of the goods is the acceptance. The *Golden Valley Grape Juice* case that follows discusses an interesting example of acceptance by conduct—the attachment of one contract to another contract. The case involved Party A sending a contract (offer) to Party B; Party B then attached that contract to an offer he made to Party C (resell the goods to be received from Party A). The question for the court was whether the attachment of the Party A contract to the Party C contract was an act of B accepting Party A’s offer to sell? The *Golden Valley* case also discusses the issue of how to incorporate standard terms into a contract and the issue of the enforceability of forum selection clauses.

Battle of Forms

Most international export transactions make use of standard forms to expedite the negotiation and conclusion of contracts. These forms, such as *pro forma* invoices, commercial invoices, price quotations, purchase orders, and

Pratt & Whitney Corp. v. Malev Hungarian Airlines

Metropolitan Court of Budapest, 13 Bp. P.O.B. 16 (1991)

Malev Airlines (defendant) entered into negotiations with Pratt & Whitney (plaintiff) to supply it with jet engines to be installed on jumbo jets that defendant was purchasing from Boeing Aircraft or Airbus of France. After carrying on thorough negotiations, Pratt & Whitney sent a

meticulously written proposal of 15 pages to defendant on December 14, 1990, with a deadline for the proposal of December 21, 1990. Defendant accepted the proposal on December 21, 1990. After numerous other discussions and correspondences, defendant informed plaintiff in a

March 25, 1991 letter that it no longer planned on buying plaintiff's engine. The issues for the court included whether the proposal without a fixed price or quantity was an offer, whether the defendant's response was an acceptance, and whether aircraft parts were covered under the CISG.

Hungarian Court. The applicable law of this case is the Vienna Sales Convention (CISG). Article 2 of the CISG excludes from coverage the sale of "ships, vessels, hovercraft, or aircraft." Does this exclusion include aircraft engines and parts? We believe that such component parts are covered as contracts relating to the production of goods as defined in Article 3 of the Convention. The defendant argues that plaintiff's proposal of December 14, 1990, was of a general informative character, not an offer, but only a letter of intent. Furthermore, there were further discussions regarding the equipment after the December 14, 1990, proposal and the merchandise was not properly defined in that proposal.

According to Article 14 of the CISG, a proposal to be an offer need only be addressed to one or more definite persons, be adequately specified, and indicate the offeror's intention to bind itself in case of its acceptance. A proposal is adequately defined if it indicates the goods and fixes the quantity and price expressly or contains provisions for their definition. We hold that the proposal leaves no doubt about its subject, that it indicates unambiguously the goods subject of the sale. Because it leaves to the buyer the exact engine to be purchased along with the quantity of the

order is not critical. The number of engines will be decided based upon the number of airplanes the defendant decides to buy in the future. The proper indication of the goods is not affected by the condition that according to the proposal the buyer could choose from among the enumerated engines. Therefore, plaintiff's proposal of December 14, 1990, was a legal offer under the CISG.

The next issue was whether defendant's response of December 21, 1990, was an acceptance under Article 18 of the CISG. It is noted that the offer contained the language that the defendant's "acceptance of this proposal is conditional upon the approvals of the governments of Hungary and the United States." This condition does not prevent the formation of a contract. Article 23 of the CISG states that a contract becomes valid when the offeror receives a notification of acceptance. We believe that defendant's response of December 21, 1990, established a valid agreement. The court finds the defendant in breach of contract under the CISG.

Case Highlights

- Although ships, vessels, and aircraft are excluded from the CISG, a sale of parts for such items is covered by the CISG.
- An offer is sufficient even if it allows the offeree to fix the quantity term at some later date.
- A conditional acceptance does not prevent the formation of a contract.

written confirmations act as the offers and acceptances in the contract formation process. The chronological order of communication will determine, for example, if a purchase order acts as an offer or as an acceptance.

Most exporters and importers will review the front page of the other party's form. Few will take the time to read and understand the "Terms and Conditions" on the reverse. Not reading the fine print or *boilerplate terms* is dangerous because the terms on the reverse side of each party's respective forms are often in conflict or contain terms that the other party would not have agreed to if it was aware of them at the time of formation. For example, the

Golden Valley Grape Juice and Wine, LLC v. Centrisys Corporation

2010 U.S. Dist. LEXIS (E. Dist. Cal. 2010)

This dispute arises from a contractual agreement between plaintiff Golden Valley Grape Juice and Wine, LLC (Golden Valley) of California and defendant Centrisys Corporation (Centrisys) of Wisconsin. Golden Valley purchased a centrifuge from Centrisys. Separator Technology Solutions Pty Ltd. (STS); an Australian business entity manufactured the centrifuge and sold it under a

separate agreement to its then distributor, Centrisys. The centrifuge proved to be defective. Golden Valley eventually filed this action against Centrisys. Centrisys then filed a third-party complaint against STS. STS's offer was contained in the February 29, 2008, sales quote to Centrisys. The sales quote identified the goods, the quantity of goods and the price as a sufficient offer under

CISG Article 14. The offer sent to Centrisys included an attachment containing the *General Conditions*. After receiving the sales quote, Centrisys then incorporated the STS quote into its presentation to Golden Valley. The terms of STS's offer were accepted because Centrisys sold the centrifuge to Golden Valley.

Centrisys argues that the mere receipt of the General Conditions is not enough to accept the conditions. Centrisys argues that it did not "accept" the terms of the General Conditions because it did not affirmatively agree to the General Conditions. Pursuant to the CISG, acceptance does not require a signature or formalistic adoption of the offered terms. Pursuant to Article 18(3), "the offeree may indicate assent by performing an act, such as one relating to the dispatch of the goods or payment of the price, without notice to the offeror; the acceptance is effective at the moment the act is performed." In the General Conditions was a forum selection clause that said any dispute would be heard in Victoria, Australia.

Court held that the issue as to whether the forum selection clause had become part of the contract between the Austrian manufacturer and American buyer was to be determined under the CISG. It concluded that Centrisys' action of including STS's price quote in its bid to Golden Valley constituted an acceptance of STS's offer including the General Conditions even though enforcement of the forum selection clause meant that Centrisys would have to bring a second lawsuit instead of combining the two claims in one lawsuit. A forum selection clause is

presumptively valid; the party seeking to avoid a forum selection clause bears a "heavy burden" to establish a ground upon which we will conclude the clause is unenforceable. Forum selection clauses should be honored "absent some compelling and countervailing reason." Citing the U.S. Supreme Court in *Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972).

For the foregoing reasons, the motion to dismiss for change of venue by Third Party Defendant Separator Technology Solutions Pty Ltd. is GRANTED.

Case Highlights

- Contracts may be formed by acceptance through a promise ("I accept") or by the conduct of the party receiving the offer. In this case the act of including the offer in a subsequent contract with another party was an acceptance that bound the contract.
- In acceptance by conduct, the offeror must have allowed for acceptance by conduct or performance instead of a statement of acceptance.
- The CISG does not provide a rule for the incorporation of General Conditions (standard terms) into a contract. The Court held that the attachment of the General Conditions to an e-mail was sufficient to make them part of the contract.
- The U.S. Supreme Court held that forum selection clauses should be enforced unless there is a strong public policy reason against their enforcement.

"Terms and Conditions" in Figure 12.1 *Focus on Transactions*: "Pro Forma Invoice" absolve the seller of any responsibility for the goods when they are delivered to any third party such as a freight forwarder or common carrier (paragraphs 1, 2, 3). This term may conflict with the trade term on the face of the form.

Paragraph 4 in Figure 12.1 makes the seller's quotations as to freight and insurance *nonbinding*. Paragraph 5 limits seller's liability for its own negligent acts to \$50 per shipment. Paragraph 6 requires the buyer to notify seller of any defects in the goods within 60 days of the date of exportation or lose its right to sue for breach of warranty. Paragraph 7 allows the seller to retain a lien on the goods for "all charges or expenses incurred by the Seller in connection with the shipment to the Purchaser." Paragraph 8 absolves seller from any governmental requirements pertaining to the shipment of the goods including marking and health regulations. Paragraph 9 mandates that any dispute must be settled in a court near the seller (City of Miami) and using the law of the seller's place of business (State of Florida). Paragraph 10 passes the costs of any litigation brought by the Seller, including attorneys' fees, to the purchaser. The one-sided nature of these terms will become important only if the parties are involved in a contract law dispute, but by the time of a dispute, it is too late for the purchaser to object to the onerous terms. Exchanging forms with conflicting or varying terms is referred to as the **battle of the forms**.

A U.S. businessperson familiar only with the UCC will be exposed to unexpected consequences under the CISG in a battle of the forms scenario. Article 19 of the CISG resolves a conflict in the exchange of forms differently than does Article 2-207 of the UCC. For example, a seller responds to a purchase order ("the offer") with a confirming invoice ("the acceptance"). The confirming invoice, however, includes an **additional term** that limits purchaser's

(Terms and Conditions)

- 1 Services by Third Parties: Unless the Company carries, stores, or otherwise physically handles the shipment, and the loss, damage, or delay occurs during such activity, the Company assumes no liability as a carrier, but undertakes only to use reasonable care in the selection of carriers, truckers, lightermen, forwarders, customhouse brokers, warehousemen, and others to whom it may entrust the goods for delivery unless a separate bill of lading or other contract of carriage is issued by the Company, in which event the terms thereof shall govern.
- 2 Liability Limitations of Third Parties: The Company is authorized to select all necessary third parties as required to transport the goods, all of whom shall be considered as the agents of the Purchaser and subject to all conditions as to limitation of liability and to all rules and regulations and conditions appearing in bills of lading or receipts issued by such third parties. The Company shall not be liable for any loss, damage, expense, or delay to the goods for any reason whatsoever when the goods are in the possession of third parties.
- 3 Choosing Routes or Agents: Unless specified by the Customer in writing, the Company has complete freedom in choosing the means, route, and procedure to be followed in the handling, transportation, and delivery of the goods.
- 4 Quotations Not Binding: Quotations as to fees, rates of duty, freight charges, insurance premiums, or other charges are for informational purposes only and are subject to change without notice unless the Company in writing specifically undertakes the transportation of the shipment at the specified rate.
- 5 Limitation of \$50 per Shipment: The Customer agrees that the Company shall in no event be liable for any loss, expense, or delay to the goods resulting from the negligence or fault of the Company for any amount in excess of \$50 per shipment.
- 6 Presenting Claims: In no event shall the Company be liable for any act or omission or default unless the claim is presented to it at its office within 60 days from the date of exportation of the goods in a written statement to which sworn proof of claim shall be attached.
- 7 General Lien on Any Property: The Company shall have a general lien on any and all property and documents relating thereto of the Purchaser in its possession or en route, for all claims for charges, expenses or advance incurred by the Company in connection with any shipments to the Purchaser, and if such claims remain unsatisfied for a period of thirty days, the Company may sell at public auction or private sale, and apply the net proceeds of the sale to the payment of the amount due Company. The Purchaser remains liable for any deficiency in the sale.
- 8 No Responsibility for Governmental Requirements: It is the responsibility of the Purchaser to know and inform the Company of the marking requirements of the country of importation, and all other safety and health regulations, and all other requirements of law or official regulations. The Company shall not be responsible for action taken or fines or penalties assessed by any governmental agency against the shipment.
- 9 Construction of Terms and Venue: The foregoing terms and conditions shall be construed according to the laws of the State of Florida. Unless otherwise consented to in writing by the Company, no legal proceeding against the Company may be instituted by either the Purchaser, its assigns or subrogee, except in the City of Miami, Florida.
- 10 Costs of Collection: Purchaser shall pay all costs, charges, and expenses including attorney's fees, reasonably incurred or paid by the Company (including attorney's fees for any appeals taken) because of the failure of the Purchaser to perform and comply with the terms and conditions of this agreement including payment of monies due and every such payment shall bear interest from the date at the highest rate permitted by law.

Figure 12.1 *Focus on Transactions*: Pro Forma Invoice.

ability to make a claim for breach of warranty by providing a short notice period. What is the legal effect of the additional notice requirement? If construed as a nonmaterial modification, the CISG and the UCC would acknowledge the contract formation, incorporating the additional term. Article 19(3) of the CISG, however, broadly defines *material* to include “among other things, price, payment, quality and quantity of the goods, place and time of delivery, *extent of one party's liability to the other*, or relating to the settlement of disputes.” In essence, the CISG adopts the old common law **mirror image rule** in which the acceptance must be a mirror image of the offer. Thus, under the CISG the additional term converts the attempted acceptance into a counteroffer, resulting in a finding of no contract.

The impact of the CISG's adoption of the mirror image rule may be profound. The use of standard forms in the formation of modern contracts is a universal practice. Invariably, any time seller's and buyer's forms are exchanged there will be conflicting terms in the fine print that neither party is likely to read unless a dispute arises. Under the CISG's broad materiality standard, the contracts thus formed are technically unenforceable.

A German court seemed to recognize the reality of standard form contracting and ignored the broad materiality definition in Article 19(3). It held that a restrictive notice provision pertaining to claims of defects was not a material term. The notice of nonconformity (defect) term would seem to come within the purview of Article 19(3) as a term relating to the “*extent of one party's liability to the other party*.” The German court's decision demonstrates that until there are enough cases interpreting the CISG, contracting parties are likely to be surprised by some

Filanto, S.P.A. v. Chilewich International Corp.**789 F. Supp. 1229 (S.D.N.Y. 1992)**

Italian footwear manufacturer brought action against New York export-import firm, alleging breach of contract. This case is a striking example of how a lawsuit involving a relatively straightforward international commercial transaction can raise an array of complex questions. Defendant Chilewich signed a contract with a Russian importer for a long-term supply of footwear. This "Russian contract" contained an arbitration clause: "All disputes are to be settled by the Arbitration Tribunal of the Chamber of Commerce in Moscow, Russia."

Chilewich then entered into negotiations with Filanto, an Italian manufacturer, to supply the shoes needed for the Russian contract. After a negotiation meeting, Chilewich sent Filanto a letter, dated July 27, 1989, that stated: "Attached please find our contract to cover the purchases from you. Same is governed by the conditions which are enumerated in the standard contract in effect with the Russian buyers, copy of which is also enclosed." Subsequently, Chilewich procured a letter of credit to the benefit of Filanto as required under the contract. Soon thereafter, Filanto began to perform on the contract.

On September 2, 1989, Chilewich received a letter from Filanto that included the following statement: "Returning back the enclosed contracts signed for acceptance, so we do not misunderstand, regarding the Russian contract, we have to respect only the following points: Packing and marking, way of shipment, delivery." After its Russian buyer rejected an earlier shipment of shoes, Chilewich never purchased a subsequent order of 90,000 pairs of boots. It is Chilewich's failure to do so that forms the basis of this lawsuit. Chilewich commenced an arbitration action in Moscow. Filanto moved to enjoin the arbitration, or alternatively, for an order directing that arbitration be held in New York rather than Moscow because of unsettled political conditions in Russia.

Brieant, Chief Judge. The facts indicate that when Filanto thought it was desirable to do so, it recognized that it was bound by the incorporation by reference of portions of the Russian contract. Also, Chapter 2 of the Federal Arbitration Act comprises the Convention on the Recognition and Enforcement of Foreign Arbitral Awards. The Arbitration Convention requires courts to recognize "any agreement in writing under which the parties undertake to submit to arbitration." The term "agreement in writing" is defined as "an arbitral clause in a contract or an arbitration agreement, signed by the parties

or contained in an exchange of letters or telegrams." The threshold question is whether these parties actually agreed to arbitrate their disputes. The Federal Arbitration Act controls this determination.

The "federal law of contracts" to be applied in this case is found in the United Nations Convention on Contracts for the International Sale of Goods (CISG). The parties offer varying interpretations of the numerous letters and documents exchanged between them. There simply is no satisfactory explanation as to why Filanto failed to object to the incorporation by reference of the Russian contract in a timely fashion. Chilewich had in the meantime commenced its performance under the Agreement by furnishing a letter of credit to Filanto. An offeree who, knowing that the offeror has commenced performance, fails to notify the offeror of its objection to the terms of the contract within a reasonable time will be deemed to have assented to those terms. The August 7, 1990, acceptance, noting its objection to the arbitration clause, to Chilewich's March 13, 1990, Memorandum Agreement was untimely due to Filanto's awareness of Chilewich's commencement of performance. Furthermore, Filanto's June 21, 1991, letter makes reference to the "Master Purchase Contract" (the Russian contract). This letter comes within CISG Article 8(3) directive that "in determining the intent of a party due consideration is to be given to any *subsequent conduct* of the parties."

Heeding the presumption in favor of arbitration, which is even stronger in the context of international commercial transactions, the Court holds that Filanto is bound by the terms of the March 13 Memorandum Agreement and so must arbitrate its dispute in Moscow. SO ORDERED.

Case Highlights

- The Federal Arbitration Act requires courts to enforce reasonable arbitration clauses. Any state law that restricts the federal policy in favor of arbitration is preempted.
- The ability of one party to add or delete contract terms in the battle of the forms scenario is lost if the party delays its response beyond a reasonable time or after the other party begins performance.
- A court will take into consideration the conduct of the parties following the formation of the contract (course of performance) when interpreting a contract.

of the decisions produced by national courts applying the CISG. One way to avoid a battle of the forms is to use a single or model contract that both parties sign.

The battle of the forms scenario is illustrated in *Filanto, S.P.A. v. Chilewich International Corp.* In that case one of the parties attempted in its offer to incorporate another document by reference. A belated acceptance attempted to delete the reference in order to avoid an arbitration clause. The issues for the court were whether a contract had been formed and, if so, under whose terms.

Contract Interpretation

The common law and the CISG take different approaches to the interpretation of contracts. Contract interpretation involves: (1) determining what makes up the contract (oral statements, written agreement, multiple written instruments); (2) determining the meaning of the contract; and (3) determining what types of evidence (written contract, prior dealings or practices between the parties, how the parties subsequently interpreted the contract in performing on the contract, and/or business customs and trade usage) should be considered in attaching meaning to the contract.

The common law uses the **objective theory of contract**, where the focus is not on the parties' actual subjective intent, but on the meaning a neutral third party (**reasonable person standard**) would attach to the parties' words and conduct (objective manifestations). The meaning of a contract is not based on what a party thought the meaning was, but on what his actions and words would be interpreted to mean under the contract. The strongest evidence of objective meaning is the written contract. Therefore, under the common law if a written contract is deemed to be the

Tee Vee Toons v. Gerhard Schubert GmbH

00 Civ 5189 (RCC) (S.D.N.Y. 2006)

In the early part of the 1990s, Tee Vee Toons (TVT) record company invented and patented a biodegradable-cardboard "flip-top" packaging called the "Biobox," which was designed to provide a secure, environmentally friendly way to package audio and video cassettes. After protracted negotiations, TVT and Schubert entered into a written contract for Schubert to build a Biobox-production system. Shortly thereafter, problems started accumulating. First, Schubert experienced delays that set the project back nearly two years and when the Biobox-production system (Schubert System) was finally finished and delivered the system malfunctioned frequently and severely. Eventually, upset with the lack of progress made in curing the Schubert System's defects, TVT commenced this action, asserting various contract and tort claims and claiming that they suffered millions of dollars in damages, including money paid to Schubert for the system and repairs, money spent on other technicians and equipment to try to fix or replace components, money spent to set up its production facility, money that will have to be spent to replace the facility, money spent on administration of the Biobox project, and lost profits.

Unlike American contract law, the CISG contains no statute of frauds; therefore, oral statements between the

parties may be used to prove a contract and the terms of the contract. The CISG "allows all relevant information into evidence even if it contradicts the written documentation." CISG Article 8 explains how such oral evidence should be interpreted:

- 1 For the purposes of this Convention statements made by and other conduct of a party are to be interpreted according to his intent where the other party knew or could not have been unaware what that intent was.
- 2 If the preceding paragraph is not applicable, statements made by and other conduct of a party are to be interpreted according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances.
- 3 In determining the intent of a party or the understanding a reasonable person would have had, due consideration is to be given to all relevant circumstances of the case including the negotiations, any practices which the parties have established between themselves, usages, and any subsequent conduct of the parties.

CISG Article 8(1) "requires a court to consider . . . evidence of the parties' subjective intent" and that Article 8(3)

“is a clear instruction to admit and consider parol evidence regarding the negotiations to the extent they reveal the parties’ subjective intent.”

TVT asserts its contract claims under Articles 35 and 36 of the CISG. TVT alleges that the Schubert System “was not fit for the ordinary purpose of an automatic erecting, loading, and closing system for a flip-top cassette carton, and it was not fit for the particular purpose for which it was ordered and purchased, namely, the rapid and reliable production of Biobox packaging cartons” in violation of Article 35(2)(a)-(b).

Schubert argues, however, that provisions in the Terms and Conditions attached to the February 1995 Quotation Contract effectively disclaim all or part of the relevant Article 35 warranties. TVT counters that: “there was an express oral understanding reached between TVT and Schubert’s agent that the onerous boilerplate language of the Terms and Conditions would *not* apply.” Unlike American contract law, the CISG contains no statute of frauds, noting that Article 8(1) “requires a court to consider evidence of the parties’ subjective intent” and that Article 8(3) “is a clear instruction to admit and consider parol evidence regarding the negotiations to the extent they reveal the parties’ subjective intent.” The matter is made more complex because one of the provisions in the Terms and Conditions section is a merger clause, which extinguishes all prior oral agreements. The question of whether, under the principles of the CISG, a prior oral agreement to disregard boilerplate language itself containing, *inter alia*, a merger clause, trumps the written merger clause itself, appears to be a question of first impression for at the very least American courts.

There exists a genuine issue of material fact as to whether Schubert and TVT shared the intent to be bound by the “Terms and Conditions.” The CISG Advisory Council has noted that “extrinsic evidence [such as the oral dealings between Schubert and TVT representatives] should not be excluded, unless the parties actually intend the Merger Clause to have this effect” and that “Article 8 requires an examination of all relevant facts and circumstances when deciding whether the Merger Clause represents the parties’ intent.” If, however, there was no shared intent of TVT and Schubert (by their agents) to be bound by either the Terms and Conditions section or Merger Clause, then the Terms and Conditions section and Merger Clause would drop out, and TVT would be entitled to the full panoply of implied warranties offered by the CISG, including the Article 35 provisions forming the basis of this contract claim. This suggests that if either party had a contrary intent, the Merger Clause between them would have no effect; only if both Schubert and

TVT shared the intent to be bound by the Merger Clause contained in the “Terms and Conditions” is the Merger Clause operative.

Summary judgment is inappropriate on TVT’s Article 35(2)(a)-(b) claim because there is a genuine issue of material fact regarding the parties’ intent to incorporate the Terms and Conditions section and Merger Clause therein. Under the guidelines set forth herein, the finder of fact in this case will be required to determine the subjective intent of the parties.

Therefore, the motion for Summary Judgment is DENIED.

Case Highlights

- Unlike American contract law, the CISG contains no statute of frauds or parol evidence rule (written contracts cannot be contradicted by other types of evidence); therefore, oral statements between the parties may be used to prove a contract and the terms of the contract.
- The CISG Article 8 adopts both the subjective (actual intent) and objective (manifestations of intent) approaches to contract interpretation. Contracts are to be interpreted based upon evidence of the parties’ actual subjective intent. If this is not possible, contracts are to be interpreted using the reasonable person standard (objective intent), that is, what would a reasonable third party witnessing the parties’ actions and words interpret the contract to mean?
- In this case, the written contract’s **standard terms** included a *disclaimer of the implied warranties* found in CISG Article 35 (implied warranty of merchantability or ordinary purpose and implied warranty for a particular purpose), however, the buyer argued that the disclaimer of warranties was not part of the contract because the parties had orally agreed that the standard terms did not apply.
- The common law’s parol evidence rule would bar the use of the evidence of the oral statements to contradict the written contract, while the CISG has no such rule and the evidence of the oral agreement would be admitted into evidence. However, the standard terms also included a merger clause, which is a contract form of the parol evidence rule that prohibits the consideration of extrinsic evidence (oral representations that the standard terms would not apply) if it contradicts the written contract (including the standard terms).
- If the court determines the parties had subjectively agreed that the standard terms would not apply despite the objective fact that they were included in

the contract, then the disclaimer would not exist and the buyer would be able to proceed with its claims of breach of the implied warranties of CISG Article 35. If the court finds that the standard terms did apply under the reasonable person standard, then the disclaimer would be effective and the merger clause would prevent the buyer from presenting evidence of the oral agreement. But, the court states a second issue if the standard terms apply, and even though the

merger clause was part of the standard terms, the court would still have to determine if the parties actually intended the merger clause to prevent the admission of extrinsic evidence that shows their true intent. The court sent the case back to the lower court to determine the parties' subjective intent relating to the enforceability of the standard terms and, secondly, the enforceability of the merger clause within the standard terms.

final agreement (integration), then other types of extrinsic evidence that would show the parties' actual intent cannot be used to contradict the written contract (parol evidence rule).

The CISG has no parol evidence rule, so all types of evidence, even oral statements that contradict the written contract are admissible evidence. Furthermore, the CISG follows the civil law approach and instructs the courts to determine the parties' actual subjective intent. The reasonable person standard (objective intent) is only to be used if the evidence is unclear as to what the parties actually intended. The *Tee Vee Toons* case that follows explores the

Frigalment Importing v. B.N.S. International Sales Corp.

190 F. Supp. 116 (S.D. N. Y. 1960)

Action by buyer of fresh frozen chicken against seller for breach of warranty. Two contracts are in suit. In the first, a New York sales corporation confirmed the sale to plaintiff, a Swiss corporation, of: "US fresh Frozen Chicken, Grade A, Government Inspected, 2 1/2 to 3 lbs. each, all chickens individually wrapped, packed in secured fiber cartons suitable for export." The second contract was identical save that only 50,000 lbs. of the heavier "chicken" were called for. When the initial shipment arrived in Switzerland, plaintiff found that the birds were not young chickens suitable for broiling and frying but stewing chickens or "fowl." Protest ensued. Nevertheless, shipment under the second contract was made again being stewing chickens. The issue is: What is a chicken? (See Image 12.2: "What Is a Chicken?")

Friendly, Circuit Judge. Plaintiff says "chicken" means a young chicken, suitable for broiling and frying. Defendant says "chicken" means any bird of the genus that meets contract specifications on weight and quality, including what it calls "stewing chicken" and plaintiff pejoratively terms "fowl." To support its claim, plaintiff sends a number of volleys over the net; defendant essays to return them and adds a few serves of its own. Assuming that both parties were acting in good faith, the case nicely illustrates Oliver Wendell Holmes' remark "that the making of a contract depends not on the agreement of two minds in one intention, but on the

agreement of two sets of external signs—not on the parties' having *meant* the same thing but on having *said* the same thing." Since the word "chicken" standing alone is ambiguous, I turn first to see whether the contract itself offers any aid to its interpretation.

Plaintiff's first contention hinges on an exchange of cablegrams, which preceded the formal contracts. After testing the market price, plaintiff accepted, and sent defendant a confirmation. These and subsequent cables between plaintiff and defendant, which laid the basis for the additional quantities under the first and for all of the second contract, were predominantly in German, although they used the English word "chicken." Defendant's agent testified that when asked plaintiff's agent what kind of chicken were wanted, received the answer "any kind of chickens." Defendant relies on conduct by the plaintiff after the first shipment had been received. Defendant argues that if plaintiff was sincere in thinking it was entitled to young chickens, plaintiff would not have allowed the shipment under the second contract to go forward.

Plaintiff's next contention is that there was a definite trade usage that "chicken" meant "young chicken." Here there was no proof of actual knowledge of the alleged usage; indeed it is quite plain that defendant's belief was to the contrary. Plaintiff endeavored to establish such a usage by the testimony of witnesses. However, one witness stated that a careful businessman protected himself by using

“broiler” when that was what he wanted and “fowl” when he wished older birds. An employee of a company that publishes a daily market report on the poultry trade gave his view that the trade meaning of “chicken” was “broilers and fryers.” Defendant provided a witness that said that in the trade, “chicken” would encompass all the various classifications of chicken. Defendant also provided a regulation of the Department of Agriculture that defined “chickens” as various classes including “*broiler or fryer*, roaster, capon, stag, hen or *stewing chicken or fowl*.”

When all the evidence is reviewed, it is clear defendant believed it could comply with the contracts by delivering stewing chickens. Plaintiff asserts that it is equally plain that plaintiff’s own subjective intent was to obtain broilers and fryers. Because plaintiff has the burden of showing that “chicken” was used in the narrower rather than in the

broader sense, and this it has not sustained, judgment shall be entered dismissing the complaint.

Case Highlights

- Four-corners analysis requires a court or arbitral panel to find the answer to the issue in dispute within the contract.
- In a totality of the circumstances analysis the court or arbitrator looks outside of the contract to interpret its meaning.
- In performing a totality of the circumstances analysis, a court applies the reasonable person standard.
- Under the reasonable person standard, the contract is interpreted from the perspective of a reasonable person in that particular trade or business.

practical applications of the subjective and objective theories of contract interpretation, and how they determine the types of evidence a court will consider in deciding a case.

A famous case of contract interpretation involved the judicial attempt to define the word “chicken.” The *Frigalimont Importing v. B.N.S. International Sales Corp.* case illustrates how a court attempts to define terms in a contract through its reading of the contract itself and its use of evidence of prior dealings, course of performance, and trade usage. It also discusses a number of important legal concepts including the **four-corners analysis**, the **totality of the circumstances**, and the **reasonable person standard**.

The *Frigalimont* case illustrates a hierarchy of tools that courts use in interpreting contracts. The first level is studying the language of the contract to determine its meaning. This is sometimes referred to as a four-corners analysis or the **plain meaning rule**. If the language is unclear, the court proceeds to the next level of analysis. It will analyze the relationship and actions of the contracting parties. First, it will look at evidence of “course of performance” of the parties for the contract in dispute. In short, the post-formation conduct of the parties will be reviewed to determine what the parties believed that the contract meant. If the meaning is still unclear, the court will study any prior contracts or dealings between the parties to infer a previously established meaning. The final level of analysis is to infer a meaning from outside such as trade usage or custom. In *Frigalimont* none of these levels of analysis provided a clear meaning for the word *chicken*. The result was the plaintiff lost because of its failure to meet its burden of proof regarding the meaning of the word.

The second and third levels of analysis are referred to as a totality of the circumstances analysis. The courts often look to circumstances surrounding the execution of a written contract to find the parties’ intent. Lord Wilberforce in *Reardon Smith Line, Ltd.*⁷ defined the totality of the circumstances analysis as the need in “commercial contracts for the court to know the commercial purpose of the contract. This presupposes knowledge of the genesis of the transaction, background, context, and the market in which the parties were operating.” The background and context include oral negotiations, prior dealings, trade usage, and custom.

The common law has long used the reasonable person standard as an aid in interpreting and enforcing contracts. The reasonable person reflects the totality of the circumstances analysis because it is often constructed using the trade usage, customs, and practices of businesspersons in a particular trade or business. The role of the reasonable person standard has become more important because of the modern innovation of standard forms, since most terms of standard forms are not the product of negotiations and conscious agreement. The reasonable person standard is used to interpret the so-called fine print or boilerplate terms to see if the terms meet the measure of commercial reasonableness.



Image 12.2 What Is a Chicken?

The traditional focus held that the act of signing a standard form was evidence that the signer intended to accept all of its terms. This approach became increasingly untenable as it became apparent that in reality there was no such actual consent; usually at least one of the parties does not read or understand the fine print of the preprinted form. The role of the reasonable person was thus expanded to determine what reasonable terms would be included and what unreasonable terms would be excluded.

Karl Llewellyn, in writing UCC Article 2 on the Sale of Goods, devised two roles for the reasonable person standard in the area of standard form contracts: (1) to interpret the meaning of the terms expressly negotiated by the parties, and (2) to determine what non-negotiated terms are to be reconstructed or expelled due to unreasonableness. The reasonable person standard is also used to determine what reasonable terms are to be inferred to fill in gaps in the contract. For purposes of determining reasonableness, the reasonable person standard looks to the terms generally found in such contracts. The reasonable person standard is used to conform the boilerplate terms to the spirit of the contract as represented by the negotiated terms and the type of transaction being undertaken.⁸

Duty to Inspect and Proper Notice

A purchaser of goods may reject delivered goods if it gives timely and effective notice of a nonconformity. What is proper notice under the CISG? The buyer has three duties: First, Article 38 (1) requires the buyer to inspect the goods “within as short a period as is practicable.” Second, the buyer must inform the seller of the nonconformity “within a reasonable time after he has discovered it or ought to have discovered it.” Any claim for nonconformity is time barred if not reported within two years of delivery to the buyer. Third, the notice to the seller must specify the nature of the nonconformity.

A German court dealt with the notion of due diligence in the inspection of goods. Following customer complaints about measurements, sewing quality, and color fading, a German retailer attempted to cancel a second order with an Italian manufacturer. The goods were shipped nonetheless. The retailer inspected only a selected sample of the shoes and failed to detect any nonconformity. Following additional customer complaints, the retailer attempted to reject the order due to nonconformity. The court found in favor of the seller, holding that the expiration of sixteen days rendered the buyer's notice as untimely.⁹ The court's rationale smacks of due diligence: Because the buyer was aware of nonconformities stemming from the first order, it should have performed a more detailed inspection of

the shoes in the second order. The court presumed that such an inspection would have uncovered the nonconformity at an earlier date.

In another case, pursuant to an installment contract a German clothing retailer gave notice to an Italian seller of fashion goods eight and twelve days after delivery of two shipments. The notice stated that the goods failed to conform because of “poor workmanship and improper fit.” The German court bypassed the issue of timeliness and held the notice ineffective due to its lack of specificity. The UCC, however, is less demanding than that required under the CISG. Initially, the rejecting party needs only to state in general terms the reason for the rejection. Comment 1 states that it is the policy of this Section to permit the “buyer to give a quick and informal notice of defects in a tender without penalizing him for omissions in his statement.”¹⁰ There is one exception to the general character of the UCC notice requirement. Where the defect in a tender is one which could have been cured by the seller, a buyer who merely rejects without stating his objections is probably acting in commercial bad faith. Except for the situation where the seller has the ability and right to cure, this clarification indicates that a general notice and not a particularized one (as required by the CISG) is sufficient to meet the dictates of the UCC.

Nachfrist Notice

Another concept foreign to Anglo-American contract law is the civil law notion of *nachfrist notice*. The underlying premise behind this concept is that a delay in performance does not in itself constitute a material breach of the contract. The notion allows a buyer or seller to fix an additional time for performance beyond that which is specified in the contract. The additional time must be of a reasonable duration. The reasonableness of the time extension will depend on the nature, extent, and consequences of the delay, along with the importance to the buyer of prompt delivery.

The civil law’s ability to affix additional time was adopted in Articles 47 through 49 and 63 of the CISG. The buyer may give notice to the seller that she will accept delivery beyond the time prescribed. The buyer is then enjoined from taking legal action during the *nachfrist* period and must accept any proper tender of performance during that period. If the seller makes a request for a *nachfrist* extension, the buyer is obligated to respond to the request. Failure to do so results in the automatic granting of the additional time. The failure of the breaching party to perform during the extension allows the other party to declare an immediate voiding of the contract. See Figure 12.2 *Comparative Law: “A Nachfrist Case Study.”*

A contract between an Italian clothing manufacturer and a German retailer provided for a schedule of delivery dates stating that the clothes were “autumn goods, to be delivered July, August, September, plus or minus.” The first delivery of the goods was made on September 26. The retailer rejected the delivery of the goods as untimely. The court rejected the buyer’s argument that the term “autumn goods” envisioned delivery of three equal shipments for the months of July, August, and September. Such misunderstandings are common given the problems of linguistic and cultural differences, along with the tendency of businesspersons toward brevity in business communications. *What could the German importer have done differently to avoid such a misunderstanding?* First, it should have defined the term “autumn goods” more carefully in order to ensure timely and qualitatively effective delivery of the goods. Second, as suggested by the German court, they could have made use of the *nachfrist* notice provision in the CISG. The purchaser should have sent notice pursuant to Article 47 of the CISG. Article 47 states that the “buyer may fix an additional period of time of reasonable length for performance by the

seller.” Article 48 allows a seller to “request” additional time for performance. Such notice of the granting of an additional time to perform is normally given in conjunction with a fixed and known delivery date. The German court held that “the buyer did not effectively void the contract by refusing acceptance of the goods *without fixing an additional period* in the previous cases of nondelivery.”

The implications of this decision could support a number of interpretations. First, the use of *nachfrist* notice in this situation would have been evidence that the parties had indeed intended multiple delivery dates throughout July, August, and September. Second, the decision holds the possibility that *nachfrist* notice may be used to fix an unspecified delivery date. At the minimum, it would have placed a burden upon the exporter to respond to the request for delivery. The failure of the exporter to respond would have allowed the German importer to declare the contract as voided and to seek substituted goods elsewhere. Article 49 provides that the “buyer may declare the contract voided in the case of nondelivery, if the seller does not deliver goods within the additional period of time fixed by the buyer.”

Figure 12.2 *Comparative Law: A Nachfrist Case Study.*

A U.S. businessperson unaware of the practice of *nachfrist* notice will be subject to unintended liabilities. She may mistake a *nachfrist* notice as a meaningless, nonlegal request for more time. Failure to respond in a proper way will result in an unintended granting of additional time and a freezing of her legal options. This likely will be compounded by her rejecting delivery of goods during the *nachfrist* period as untimely resulting in liability for the purchase price, along with possible additional freight and storage costs. The existence of an express “time of the essence” clause is unlikely to provide a party any further protection from the use of *nachfrist* notice. It is important for a businessperson to realize that the receipt of seemingly meaningless communications should be fully investigated for legal consequences.

Seller’s Right to Cure

The seller’s **right to cure** defective goods under the CISG is broader than to that offered in the UCC. Section 2-508 of the UCC allows a seller to cure the delivery of defective goods if the time for performance has not expired. Article 48 of the CISG allows the seller to cure after the contract date for delivery unless such late delivery would cause the buyer “unreasonable inconvenience or uncertainty.” The buyer retains the right to sue for damages and expenses caused by the delay or by the initial delivery of nonconforming goods.

Anticipatory Breach and Adequate Assurance

Anticipatory breach is a concept of Anglo-American legal derivation. The civil law does not recognize the right of a party to avoid or suspend their contract obligation in anticipation of a breach by the other party. Contract avoidance is permitted only at the time of breach or by way of a court order. Article 71 of the CISG allows a party to suspend its performance if it becomes clear that the other party will not perform. It gives two broad grounds for anticipatory breach: First, the other party has become seriously deficient in its ability to perform or in its creditworthiness. Second, the other party’s preparation or lack of preparation or insufficiency of its performance to date has called into question its ability or willingness to perform under the contract. When one party anticipates a breach of the other party and suspends performance, it must give immediate notice of the suspension.

The suspending party must lift its suspension in the event that the other party provides **adequate assurance** that it will perform as contracted. Section 2-609 of the UCC provides a similar device for suspending performance. It states that when reasonable grounds for insecurity arise with respect to performance, the concerned party “may in writing demand adequate assurance of due performance” and may suspend performance until such time as such assurance is given. Failure to give such adequate assurance within a reasonable time, not exceeding thirty days, results in a repudiation (termination) of the contract.

Damages

The damage provisions in the CISG are found in Articles 74 to 77. Article 74 provides the general measure of damages. It adopts the common law rule that damages should be limited to those that were foreseeable at the time of contract formation—what are popularly known as the rules of *Hadley v. Baxendale*.¹¹ The damages that can be collected are restricted in three ways. First, only foreseeable **consequential damages** related to the breach may be sued upon. Article 74 states that “damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract.” Second, damages will be limited to those that are provable with some degree of certainty. Therefore, purely speculative damages may not be collected.

Third, Article 77 provides that even if the loss was foreseeable and its amount is certain, the non-breaching party will be limited in his recovery in the event he failed to mitigate his damages. Article 77 provides that if he “fails to take such measures to mitigate the loss, the party in breach may claim a reduction in damages in the amount by which the loss should have been mitigated.” For example, if a buyer has a source for substituted goods, he must make efforts to obtain those substituted goods. If he does not he will be precluded from collecting

full loss of profits damages. This is similar to the rule adopted in Section 2-715 of the UCC that holds the breaching party liable for all damages that *could not reasonably be prevented*. In the case of a fundamental breach, Article 75 allows the non-breaching party to void the contract. It also authorizes the non-breaching party to obtain substituted goods. The non-breaching party may then sue the breaching party for the difference between the contract price (of the voided contract) and the price, if higher, of the substituted goods. If the non-breaching party elects not to procure substituted goods, it may in the alternative sue for lost opportunity damages. Article 76 of the CISG allows him to recover for the difference between the contract price and the market price at the time of avoidance (termination).

Delchi Carrier, S.P.A. v. Rotorex Corp.

71 F.3d 1024 (2d Cir. 1995)

The case involved a warranty dispute between a U.S. seller of compressors (“Rotorex”) and an Italian purchaser (“Delchi”). The trial court determined that the compressors failed to conform to the specifications provided in the contract or the sample provided by Rotorex to Delchi. After Rotorex failed to cure the defects, Delchi brought suit for breach of contract and recovery of damages, including consequential damages for lost profits. The lost profits were allegedly due to lost volume caused by a closing of the assembly line for four days until the compressors were repaired. They also sued for incidental damages such as the cost to repair the compressors, the cost of storage, and the costs of expediting substitute goods.

Winter, Circuit Judge. The governing law of this case is the CISG. Article 74 allows for Delchi to collect monetary damages that are equal to its loss, including lost profits. Those damages are limited, however, to damages foreseeable at the time of the formation of the contract. Its first claim of damages is the cost of repairing the nonconforming compressors. These damages are recoverable because they were a foreseeable result of Rotorex’s breach. Hence, Delchi is entitled to expenses for repairing the units including labor cost, costs of extraordinary inspections, and testing of the units. Pursuant to Article 77 of the CISG Delchi attempted to mitigate its losses by expediting a shipment of previously ordered Sanyo compressors. The expedited shipment cannot be considered as *cover* under Article 75, because they were previously ordered. Nonetheless, Delchi’s actions in expediting the shipment were both commercially reasonable and reasonably foreseeable. Therefore, Delchi is entitled to recover the additional cost of air shipment over the cost of ocean shipment. Delchi is also entitled to the incidental costs of handling and storage of the rejected compressors.

The CISG permits recovery of lost profits resulting from a diminished volume of sales. In conformity to the common law, to recover lost profits under the CISG, a party must provide sufficient evidence to estimate the

amount of damages with reasonable certainty. Delchi proved with sufficient certainty a total lost profit of 546,377.62 lire. Delchi did not prove with sufficient certainty lost sales from “anticipated profits.” Delchi’s claim of 4,000 additional lost sales in Italy is supported only by speculative testimony of Italian sales agents who stated they would have ordered if more were available. Delchi provides no documentation of additional lost sales in Italy and that Delchi’s inability to fill those orders was directly attributable to Rotorex’s breach.

Delchi is entitled to compensatory damages for those expenses incurred in repairing nonconforming goods, obtaining substituted goods, storage of rejected goods, and reasonably certain lost profits. Lost profits do not include profits that arise from anticipated sales that cannot be determined by reasonable certainty.

Case Highlights

- Article 74 of the CISG allows a party to collect any foreseeable damages incurred due to a breach of contract.
- Article 77 of the CISG requires the plaintiff to mitigate its damages. Expenses incurred, such as expediting shipment of substitute goods, are recoverable against the breaching party.
- The plaintiff may also collect incidental damages, such as costs incurred in repairing, storing, and protecting the defective goods.
- A plaintiff may collect lost lost profits caused by delivery of defective goods, but only those profits that can be proven with reasonable certainty.
- In sum, under the CISG and the UCC, damages are restricted by three principles: (1) they must have been foreseeable at the time that contract was signed, (2) they were not caused by the plaintiff’s failure to mitigate, and (3) they must be proven with reasonable certainty and are not merely speculative.

Goods to be merchantable must:

- a pass without objection in the trade under the contract description; and
- b in the case of fungible goods, are of fair average quality within the description; and
- c are fit for the ordinary purposes for which such goods are used; and
- d run, within the variations permitted by the agreement, of even kind, quality, and quantity within each unit and among all units involved; and
- e are adequately contained, packaged, and labeled as the agreement may require; and
- f conform to the promises or affirmations of fact made on the container or label if any.

Comment 2: The question of when the warranty is imposed turns on the meaning of the terms of the agreement as recognized in the

trade. Goods delivered under an agreement made by a merchant in a given line of trade must be of a quality comparable to that generally acceptable in that line of trade under the description of the goods used in the agreement.

Comment 8: Fitness for the ordinary purposes for which goods of the type are used is a fundamental concept of the present section and is covered in paragraph (c). As stated above, merchantability is also a part of the obligation owing to the purchaser for use. Correspondingly, protection, under this aspect of the warranty, of the person buying for resale to the ultimate consumer is equally necessary, and merchantable goods must therefore be *honestly* resalable in the normal course of business because they are what they purport to be.

Note: The CISG also specifically makes it a breach of warranty if the seller fails to adequately package the goods for shipment.

Figure 12.3 Comparative Law: UCC Section 2-314(2).

The *Delchi Carrier, S.P.A. v. Rotorex Corp.* case that follows examines the different types of damage available in a typical breach of contract case. The case involves the delivery of defective goods. The goods involved in the transaction were component parts used by the buyer in the production of air conditioning units. The court assesses the damages that the buyer may collect when the delivery of defective goods results in a production slowdown at its plant. The court also decides on the types of out-of-pocket expenses the buyer can collect against the seller.

Unlike the UCC, the CISG does not allow for recovery for breach of warranty that results in injury to persons or property. Article 5 of the CISG states that it does not cover claims resulting from the “liability of the seller for death or personal injury caused by the goods to any person.” Therefore, **products liability** remains to be determined under national laws. In contrast, Section 2-715 of the UCC allows for the recovery of consequential damages stemming from the seller’s breach due to “injury to person or property proximately resulting from any breach of warranty.”

Warranty Provisions

The CISG’s warranty provision mimics the warranty provisions found in the UCC. The warranties that are of concern to most seller-exporters are any implied warranties that a court may use to hold the seller liable for nonconforming goods. Section 2-314 of the UCC recognizes the two common-law implied warranties of merchantability and particular purpose. See Figure 12.3 *Comparative Law*: “UCC Section 2-314(2).” A sale of fungible commodities is normally governed by the **implied warranty of merchantability**. Section 2-314 states it is

T.J. Stevenson & Co. v. Bags of Flour

629 F.2d 338 (5th Cir. 1980)

An *in rem* action, stemming from insect infestation of wheat flour, was brought by an ocean carrier which claimed a lien on the cargo for freight, detention, and expenses, and also sought recovery of damages from milling company (seller) and shipper consignee (buyer), the Republic of

Bolivia. The miller filed counterclaims against Bolivia and the carrier and Bolivia counterclaimed for breach of warranty. The Republic of Bolivia had entered into a contract for the purchase of 26,618 metric tons of flour from ADM Milling Co. The contract contained the following delivery

term: “Delivery of goods by SELLER to the carrier at point of shipment shall constitute delivery to BUYER.” Upon satisfactory delivery, the price was payable by irrevocable letter of credit. The contract also contained an express warranty of merchantability: “Seller warrants that the product sold shall be of merchantable quality.” The warranty clause contained the following notice requirements: “BUYER hereby waives any claim based on the quality of the goods unless, within twenty days of the arrival of goods at destination, BUYER sends SELLER a letter by registered mail specifying the nature of the complaint.”

Brown, Circuit Judge. With this decision we hopefully end, in all but a minor respect, an amphibious imbroglio and commercial law practitioner’s nightmare involving a shipload of flour. Without pause to reflect on the complications that simple insects—confused flour beetles or otherwise—can create in the lives of men and Courts, we proceed to explain our decision. One issue permeates this case: What was the source of the flour infestation? The District Judge rightly concluded that infestation began either on the rail cars or at the mill supplying the flour. Neither the warehouses nor the ships were the source of any significant infestation.

The Warranty

The District Judge rightly held that the flour failed to meet the express warranty provision of the contract. The court held that the degree of infestation was substantial and, therefore, there was a violation of the implied warranty of merchantable quality. The Uniform Commercial Code Section 2-314(2) defines merchantable as goods that “are fit for the ordinary purposes for which such goods are used.” Official Comments 2 and 8 provide helpful clues to divining the parties’ intent. Comment 2: “Goods delivered under an agreement made by a merchant in a given trade *must be of a quality comparable to that generally acceptable in that line of trade.*” Comment 8: “Merchantable goods must be *honestly resalable in the normal course of business because they are what they purport to be.*” We have often recognized that no food is completely pure. The FDA has long permitted very small amounts of insect fragments and other *dead* infestation in food products.

Here the question is: How much live infestation renders consumer-destined flour unfit for the ordinary purposes for which it is used? The evidence indicates that consumer-intended flour containing substantial amounts of live infestation is not merchantable under prevailing standards. Trade usage and course of dealing point to but one conclusion: Although flour may be “fit for human consumption” in the sense that it can be eaten without

causing sickness, it is nonetheless not of merchantable quality.

Risk of Loss

Since it has been established that consumer-intended flour containing substantial amounts of live infestation is unmerchantable and the infestation in this case began before the flour reached the State Docks warehouses, we are confronted with the issue of which party is to be responsible for the further infestation of the flour as it stood in the warehouses or lay in Stevenson’s ships. The delivery term in the contract read as follows: “F.A.S. MOBILE, ALABAMA for export.” Section 2-509(1) of the Uniform Commercial Code reads that where there is no breach and where the contract requires the seller to ship the goods by carrier then: “if it does not require him to deliver at a particular destination, the risk of loss passes to the buyer when the goods are duly delivered to the carrier.” However, Section 2-510(1) provides that in case of breach “where a tender or delivery of goods so fails to conform to the contract as to give a right of rejection the risk of their loss remains on the seller until cure or acceptance.” Since it was materially nonconforming at the time it arrived in Mobile, Bolivia could have rejected the flour at that time. We therefore conclude that under Section 2-510(1)’s plain language, the risk of loss of the infested flour remained on the seller.

Breach of Warranty and Fundamental Breach

In order for Bolivia to win on its warranty claim it must satisfy the relevant notice requirements. Section 2-607(3) (a) of the UCC states that: “the buyer must within a reasonable time after he discovers or should have discovered any breach notify the seller of breach or be barred from any remedy.” Furthermore, the contract added the contractual requirement that notice must be in writing “within twenty days after arrival of the goods.” ADM contends that under Section 2-607(3)(a) and the contract provision, it never received adequate notice of the defects. The facts show that there were informal communications throughout the time there were problems with the flour. The parties were in “continuous communication” with one another from the time the infestation problems were found. Also, Bolivia telexed ADM that no further payments would be permitted under the “irrevocable” letter of credit. From this view of the parties’ course of conduct, one may infer that ADM was aware of Bolivia’s dissatisfaction with the flour. Its awareness operated as a waiver of the specific notice

provisions of the contract. ADM's reply to the telex as well as its informal communications dealt with the substance of Bolivia's complaint and did not fault Bolivia for failing to comply with the contract's notice requirements. ADM's responses to Bolivia's initial complaints established a course of performance in which the registered mail requirement of the contractual notice provision could be disregarded.

Defendant (seller) was liable for breach of warranty and its argument that it did not receive adequate notice is rejected.

Case Highlights

- Under the UCC any defect is ground for rejection. The CISG gives a right of rejection only if there is a fundamental breach.
- The court disregarded the specific notice requirements of the contract by imputing actual notice from the actions and correspondence between the parties after the goods were delivered.
- FAS stands for Free Alongside Ship. Under this term the risk of loss to the goods is transferred to the buyer when the goods are delivered to the port of shipment and ready for loading onto the ship. However, the court found that since the goods were defective upon delivery to the ship the risk of loss never passed to the buyer. FAS (Free Alongside Ship) is a trade term that will be discussed in detail in Chapter 14.
- If nonconforming goods can be resold for another purpose, then a court, under the CISG, is likely to find that the breach did not constitute a fundamental breach. In such a case the buyer has no right to reject the goods. Instead, the buyer may make use of the price reduction remedy provided for in the CISG. Under this remedy the buyer can unilaterally reduce the price of the goods by the difference in value between the goods in their defective condition and the value of conforming goods.

implied that for the goods to be merchantable they must be "fit for the ordinary purposes for which such goods are used." For example, a 20,000 BTU air-conditioning unit should produce 20,000 BTU of air conditioning.

The **implied warranty for a particular purpose** entails conveying specific requirements from the buyer to the seller. This communication is generally done to take advantage of the seller's superior knowledge or expertise in selecting or producing the product. Article 35 of the CISG states that the goods are to conform to "any purpose expressly or impliedly made known to the seller" at the time of the formation of the contract. Thus, if you visit a licensed air-conditioning company and discuss your needs for air-conditioning, the seller is implied to warrant that the unit being provided is sufficient for your needs. If the air-conditioning company sells you a 20,000 BTU unit that performs as advertised by producing 20,000 BTU, it will be considered defective when in fact your needs dictated a unit with a 50,000 BTU capacity.

The *T.J. Stevenson* case that follows discusses the warranty of merchantability and the importance of giving notice when receiving defective or nonconforming goods. Failure to give timely notice will result in the buyer losing her right to remedies, including the right to reject the defective goods and the right to sue for damages.

It is common for parties to enter long-term supply contracts that entail multiple shipments or installments of goods. A key issue is: Does a shipment or installment of nonconforming goods allow the buyer to terminate the contract for fundamental breach or does the buyer only have the right to reject the single installment? Figure 12.4 *Comparative Law: "Hong Kong Sales Ordinance"* frames the issue of breach as it relates to installment contracts.

Section 33: Delivery by Installment

(1) Unless otherwise agreed, the buyer of goods is not bound to accept delivery thereof by installments. (2) Where there is a contract for the sale of goods to be delivered by stated installments, which are to be separately paid for, and the seller makes defective deliveries in respect of one or more installments, or the buyer

neglects or refuses to take delivery of or pay for one or more installments, it is a question in each case depending on the terms of the contract and the circumstances of the case, whether the breach of contract is a repudiation of the whole contract or whether it is a severable breach giving rise to a claim for compensation but not to a right to treat the whole contract as repudiated.

Figure 12.4 *Comparative Law: Hong Kong Sales Ordinance.*

LICENSE: The User shall have a nontransferable license to modify and use the product for functions performed in User's business. This product is sold to the purchaser under this Agreement to be an end user to be modified for certain functions as specified in the documentation for the product. The product includes both hardware and firmware that is proprietary to the seller who retains said rights. RESALE OR OTHER TRANSFER OF THE PRODUCT BY THE FIRST PURCHASER IS A VIOLATION OF THE TERMS OF THIS AGREEMENT. ANY AND ALL WARRANTIES ARE TERMINATED UPON SUCH A TRANSFER.

The User may NOT duplicate, disassemble, modify, translate, or use the Firmware other than as expressly authorized in this Agreement. Upon termination of the license, the User shall destroy all copies of and modifications to the Firmware.

LIMITED WARRANTY & DISCLAIMER: EXCEPT AS EXPRESSLY SET FORTH, THE PRODUCT IS PROVIDED TO THE ORIGINAL USER "AS IS," WITHOUT WARRANTY OF

ANY KIND, EITHER EXPRESSED OR IMPLIED, INCLUDING, BUT NOT LIMITED TO, ANY IMPLIED WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE.

LIMITATION OF REMEDIES: Seller's entire liability and User's exclusive remedy shall be: Repair and replacement including materials and labor for a period of one year unless the product has been abused, misused, or modified. IN NO EVENT WILL SELLER BE LIABLE TO THE USER FOR ANY DAMAGES, INCLUDING ANY LOST PROFITS, INCIDENTAL OR CONSEQUENTIAL DAMAGES ARISING OUT OF THE USE OR INABILITY TO USE THE PRODUCT. THE USER FURTHER AGREES THAT THIS DOCUMENT IS THE COMPLETE AND EXCLUSIVE STATEMENT OF THE AGREEMENT BETWEEN THE USER AND THE SELLER, WHICH SUPERSEDES ANY PROPOSAL OR PRIOR AGREEMENT, ORAL OR WRITTEN.

Figure 12.5 *Focus on Transactions*: Limited Liability and Disclaimer in Software Contracts.

Disclaimer of Warranty

Often a seller will attempt to disclaim all warranties, express or implied, or will want to limit its liability through a **limited express warranty**. The UCC allows for such **disclaimer** only by the use of clear and conspicuous language. Language such as the "Purchaser Takes As Is" is considered clear disclaimer language. Also, the disclaimer must be conspicuous; it must be easily noticeable when reviewing the contract. It cannot be placed in fine print on a page filled with fine print terms. In contrast, the CISG provides no formal requirements for disclaimers. Any form of disclaimer is enforceable under the CISG. Figure 12.5 *Focus on Transactions*: "Limited Liability and Disclaimer in Software Contracts" was taken from the American Bar Association's collection of software contract forms. It illustrates the disclaimer language often used by merchants.

In Figure 12.5, some of the language is printed in capital letters. This capitalization is meant to satisfy U.S. law that requires disclaimers of implied warranties to be conspicuously stated so as to alert a buyer of the existence of the disclaimer. There is no conspicuousness requirement in the CISG. Therefore, a disclaimer may be placed within the fine print terms. The final sentence of the disclaimer is an example of a merger clause. It is meant to bar the buyer from claiming that the seller through oral representations or other documents gave a different warranty. However, under the CISG this other evidence may still be admitted since the CISG states that a contract "may be proved by any means, including witnesses."

Contractual Excuses

All legal systems provide relief for someone who despite good faith intentions is unable to perform. Although in technical breach of the contract, the court will excuse the breaching party from claims of damages. The common law fabricated the **doctrine of impossibility** and the **doctrine of frustration**. The former requires the contracting party to be objectively prevented from performing and generally entails the destruction of the subject matter of the contract. Under the doctrine of frustration, the performance may still be objectively possible but the reason for the performance has ceased. For example, a hotel charges five times its normal rate for the weekend of the Super Bowl. Because of the threat of a hurricane, the Super Bowl is postponed. The purpose for renting a room at the exorbitant rate has been frustrated. The booking agent or renter will be relieved of its obligations to pay for the room.

The availability of contractual excuses in the civil law countries vary. In Belgium and France, *pacta sunt servanda* or sanctity of contract generally prevails over any request for an excuse. If the contract does not provide an

excuse through a *force majeure* clause, then the contract will be enforced without any modification to its terms. In England, the doctrine of frustration remains the premier excuse doctrine. The parties are relieved of their contractual obligations as of the date of frustration; the courts do not have the authority to modify or reform the contract. In Germany, if the “basis of the transaction” has evaporated, then the courts are free to excuse a party or to reform (adjust) the contract in accordance with the changed circumstances.

The UCC and the CISG possess their own excuse provisions. The UCC provision found in Section 2-615 is popularly referred to as the **doctrine of impracticability**. It excuses a party from performing if the performance has been “made impracticable by the occurrence of a contingency the nonoccurrence of which was a *basic assumption*” of the contract. Article 79 of the CISG allows for an excuse if nonperformance is due to an **impediment** that is beyond the control of the breaching party and was not foreseeable at the time of contract formation. However, the excuse is not permanent; performance is suspended for the duration of the impediment. The person attempting to exercise an Article 79 impediment must give prompt notice of the impediment to the other party. Failure to do so exposes the party to damages resulting from not giving notice.

All the excuse doctrines revolve around all or some of the following parameters: unforeseeability, undue hardship, and being beyond the party’s control. Most excuse doctrines require that the changed circumstances were **objectively unforeseeable** at the time of contract formation. If they were foreseeable, then the losses resulting from the breach will be considered as allocated risk. The breaching party will be susceptible to full contract damages. **Undue hardship** generally means more than a mere loss. The fact that the contract becomes unprofitable for one of

International Chamber of Commerce

Case No. 6281 of 26 August 1989

On August 20, 1987, the parties entered into a contract for the sale of 80,000 metric tons of steel bars at a price of \$190 per ton with delivery to a port in Yugoslavia. The contract provided the buyer with an option to purchase an additional 80,000 metric tons. On November 27, 1987, the buyer informed seller that it would exercise the option. The seller requested \$215 per ton for the additional delivery. On January 26, 1988, the buyer purchased 80,000 tons from another supplier at a price of \$216 and brought suit against seller for the difference between the original contract price and the price spent for the substituted goods.

Paris, France. The arbitrator decided that Yugoslav law was applicable. The arbitrator noted that Article 133 of the Yugoslav Law on Obligations allowed for a rescission of a contract due to “changed circumstances.” The seller argues that it should be released from the contract due to changed circumstances, namely the increase in the market price of steel. Article 133 does list “economic events, such as extremely sudden and high increases or decreases of prices” as one of the reasons resulting in a frustration of a contract. However, a party cannot make such a claim if he should have taken such circumstances into account at the time of contracting. The world market prices of products, such as steel, fluctuate, as is known from experience. Also, the amount of damage must exceed a reasonable entrepreneurial risk. An increase in market prices from \$190 to \$215

amounts to slightly less than 13.16%. This increase is well within the customary margin. Furthermore, the development was also predictable. A reasonable seller had to expect that steel prices might go up further.

The buyer’s purchase from another supplier, however, cannot be interpreted as a substitute purchase because he had failed to inform the seller of his intention to do so. Thus buyer’s damage is limited to the difference between the \$190 and \$215 and not the \$216 replacement price. It should be remarked in passing that the outcome would have been the same under Articles 74 to 77 of the CISG.

AWARD: Seller shall reimburse the buyer in the amount of \$2,000,000 ($80,000 \times \25).

Case Highlights

- Most price or cost increases will not be considered the type of unforeseeable event that provides a party an excuse for breaching a contract.
- Losses due to cost increases, market price changes, or currency fluctuations are considered allocated risks and are to be borne by the party that is allocated the risk in the contract.
- The non-breaching party may have to agree to a price increase under the duty to mitigate damages. It would then be able to recoup the price increase by suing for damages.

the parties is insufficient; the loss must be near catastrophic. Beyond control means the event is a type of *force majeure* or superior force. The UNIDROIT Principles summarize these factors:

- Occurrence of an event or hardship that *fundamentally alters* the contractual equilibrium due to a change in costs or values
- Occurrence was not known and the events could not *reasonably* have been taken into account at the time of the conclusion of the contract
- Occurrence was *beyond the control* of the breaching party

Frustration

In some countries, such as the United Kingdom, the excuse of commercial frustration remains the primary excuse doctrine. Commercial frustration does not require that the subject matter of the contract has become objectively impossible to perform. Instead, due to changed circumstances, the purpose or the value of the subject matter of the contract has been severely diminished. The following International Chamber of Commerce *Arbitration Case No. 6281* involves a seller's attempt to claim frustration for an increase in the market price of steel.

Force Majeure Clause

The *force majeure* clause lists the type of events that allow the parties an excuse out of the contract. *Force majeure* events may include wars, blockades, strikes, governmental interference or approval, fire, transportation problems, and others. The parties are free to recognize any event as one to be given *force majeure* effect. A *force majeure* clause should be custom drafted to take into account the type of industry, the countries, and type of carriage (transport) involved.

A *force majeure* clause allows a party to terminate its obligations under a contract due to the occurrence of something described in the clause.

In *Harriscom Svenska v. Harris Corporation*¹² the *force majeure* clause enabled a seller to avoid liability for not performing on a contract. An Iranian distributor filed a breach of contract claim against a manufacturer of radio communications products. The manufacturer claimed an excuse under the agreement's *force majeure* clause. It claimed that the U.S. government prohibition on all sales to Iran of goods it categorized as military equipment was a *force majeure* event. The U.S. State Department began a commodity jurisdiction proceeding, authorized by the Arms Export Control Act, to decide whether the radio was a military product that should be on the government's Munitions List. Placement on the list would require the manufacturer to obtain export licenses for all its sales of the radio, not just those to Iran. The manufacturer negotiated a compromise in which it agreed to "voluntarily withdraw from further sales to the Iranian market." In exchange, the government agreed that the radio was not subject to the stringent export controls of Munitions List products.

One of the issues before the court was whether the manufacturer's failure to ship spare radio parts was a voluntary act was due to a *force majeure*. Other issues included whether the defendant was released under the *force majeure* clause that excused performance under circumstances of governmental interference, whether the voluntary nature of defendant's compliance negated the excuse, and whether the defendant was required to give substituted performance through its Indian licensee. Despite the voluntary nature of the defendant's actions, the court held that the government had undoubted power to compel compliance. Like commercial impracticability, a *force majeure* clause excuses nonperformance when circumstances beyond the control of the parties prevent performance. The court held that the governmental interference in this case was such a circumstance.

The *force majeure* clause that excuses a breaching party from liability for nonperformance is common under most national legal systems. *Force majeure* refers to "extraordinary events independent of the parties' will that cannot be foreseen or averted by them with due diligence, being beyond their control and preventing the contracting party from fulfilling the obligation undertaken in the contract."¹³ Most *force majeure* events require four criteria in order to satisfy the requirements of most national laws: (1) the event must be external to the transaction and the parties, (2) it must render the performance radically different from that originally contemplated, (3) it must have been unforeseeable (objectively), and its (4) occurrence must be beyond the control of the party to prevent.

The importance of a well-drafted *force majeure* clause is illustrated by the case of *Bende & Sons, Inc. v. Crown Recreation, Inc.*¹⁴ In that case a U.S. seller of combat boots sought an excuse for nonperformance due to the derailment of the train transporting the boots. He sought the excuse of commercial impracticability under Section 2-615 of the UCC. Section 2-615 provides for an excuse for nonperformance when performance is “made impracticable by the occurrence of a contingency the nonoccurrence of which was a basic assumption on which the contract was made.” Surprisingly, the court rejected the defense, holding that the derailment was an allocated risk because “common sense dictates that they could easily have foreseen such an occurrence!”

In *Phillips Puerto Rico Core, Inc. v. Tradax Petroleum*¹⁵ liability rested upon the interpretation of a standard *force majeure* clause in relationship to the trade term in the contract. The clause in question read as follows:

FORCE MAJEURE: In the event of any strike, fire or other event falling within the term Force Majeure preventing or delaying shipment or delivery of the goods by the seller then the contract period of shipment or delivery shall be extended by 30 days on telex request made within seven days of its occurrence. Should shipment or delivery of the goods continue to be prevented beyond 30 days, the unaffected party may cancel the unfulfilled balance of the contract. Should the contract thus be cancelled and/or performance be prevented during any extension to the shipment or delivery period neither party shall have any claim against the other.

In *Phillips Puerto Rico Core, Inc.*, the Cost and Freight (C&F) contract was entered for the purchase of a product to be shipped from Algeria to Puerto Rico. The U.S. Coast Guard unexpectedly detained the ship while in transit. The purchaser brought suit against the seller for breach of contract, and the seller claimed an excuse by invoking the *force majeure* clause. The court held that the defense was not necessary because under the C&F term the risk of loss had already passed to the purchaser at the port of shipment.

The *force majeure* clause should be a highly negotiated, customized provision dealing with the particulars of the specific parties and specific type of contract. Unfortunately, most contracts, domestic and international, utilize vaguely worded standard *force majeure* or exemption clauses. The International Chamber of Commerce has developed a more elaborate *force majeure* clause.¹⁶ The following is an edited version of the ICC clause:

A party is not liable for a failure to perform if he can prove that: (1) the failure was due to an impediment beyond his control, (2) he could not have reasonably foreseen the impediment at the time of contract formation, and (3) he could not have reasonably avoided or overcome its effects.

An impediment includes but is not limited to:

- a War, hostilities, and acts of piracy,
- b Natural disasters,
- c Explosions, fires, and destruction of machinery,
- d Boycotts, strikes, lock-outs, and work stoppages which occur in the enterprise of the party seeking relief,
- e Acts of authority.

A party seeking relief pursuant to this clause shall give notice as soon as practicable. Failure to give timely notice makes the party liable in damages for losses that could otherwise have been avoided. Notice shall also be given when the impediment ceases.

The relief granted under this clause is a postponement of the time for performance for such period as may be reasonable. The non-breaching party may also suspend his own performance. Either party may terminate the contract in the event that the impediment persists for a period of ____ days. Upon the termination of the contract, each party may retain whatever he has received, but must account to the other party for any unjust enrichment.

The concept of *force majeure* or excuse has been incorporated in Article 79 of the CISG. Article 79 refers to a *force majeure* event as an impediment. *Impediment* does not mean inconvenient, or more costly, or difficult to perform. The non-foreseeable requirement is generally interpreted as reasonably non-foreseeable since technically everything is foreseeable in hindsight. “The clause refers to what a party could reasonably be expected to take into account and to make contingency plans for when entering into the contract.” Regarding the impediments enumerated above: work stoppages or strikes at a supplier or subcontractor are generally not sufficient causes. This presumption may be overcome if, for example, the contract specifies the use of the particular supplier or subcontractor.

Since the *force majeure* clause generally does not recognize changes in circumstances that result in mere hardship, the parties may expand the clause to include events that make performance not impossible but unduly costly. Such a clause is referred to as a **hardship clause**. The ICC has published a manual titled “*Force Majeure and Hardship*,” which asserts that an occurrence that “fundamentally alters the contractual equilibrium by placing an excessive burden on one of the parties” allows that party to request a revision of the contract. The requesting party must make the request within a reasonable time. The parties are to consult in good faith in the hope of amicably revising the contract. If no agreement is reached within a specified period of time then “the parties are to submit the case to the ICC Standing Committee for the Regulation of Contractual Relations for a nonbinding decision or either party may submit the issue for binding arbitration pursuant to the contract’s arbitration clause.” The hardship provision is especially warranted for long-term or multiple installment contracts.

Another *force majeure*-type of clause that can be considered is the *government approval clause*. If some government permit, license, or approval is required in order to perform under the contract, then the parties may elect to have the approval be a *condition precedent* (contract does not become enforceable and a party is not liable for damages until the condition is satisfied) to the contract. This type of provision is especially appropriate in an intellectual property transfer transaction in a country where government approval is required. A simple government approval clause in an export contract would read: “Seller shall obtain all necessary permits, licenses, or approvals to export the goods. Buyer shall obtain all necessary permits, licenses, or approvals to import the goods. This contract is not fully executed and enforceable until such approvals have been received.”¹⁷

Limitation Period

Another important contract law issue is the statute of limitations or warranty period that will be applied to any future claims of the parties. It is always advisable for the parties to agree upon a reasonable limitation period. But what is a reasonable limitation period? When does the limitation period commence? Should there be any instances when the limitation period should be stopped or “tolled”? The United Nations’ sponsored **Convention on the Limitation Period in the International Sale of Goods** provides uniform rules governing the period of time within which a party may bring a claim in conjunction with a contract for the international sale of goods.

The Convention prescribes a four-year limitation period for most claims. Article 2 of the Convention defines an international sale as one in which “the buyer and seller have their places of business in different states.” Article 22 states that the limitation period cannot be modified through contract; however, it does make an exception for arbitral proceedings. “The provisions of this Article shall not affect the validity of a clause in the contract of sale which stipulates that arbitral proceedings shall be commenced within a shorter period of limitation.” However, the four-year limitation period, even if applicable, can be truncated through the adoption of restrictive notice provisions. Article 1 states that: “this Convention shall not affect a particular time-limit within which one party is required, as a condition for the acquisition or exercise of his claim, to give notice to the other party or perform any act other than the institution of legal proceedings.” Also, the Convention does not apply to certain types of claims. For example, claims for personal injury caused by defective products and claims on bills of exchange or drafts are not governed by the Convention (Article 5).

The Convention outlines rules for the determination of the commencement of the limitation period and when the period is to be tolled or suspended. Article 9 provides the general rule that the limitation period commences on the

date that the “claim accrues.” This date is further defined in Article 10 as the date when a breach of contract occurs. Other commencement dates are provided for acts of fraud and claims of defects. “A claim arising from a defect or other lack of conformity” accrues on the date on which the “goods are handed over to or their tender is refused by the buyer.” The period for a claim of fraud commences on the date that the fraud was discovered or “reasonably could have been discovered.”

A tolling of the limitation period is granted when there is a submission to arbitrate the claim. Article 14 states that when the parties submit a claim to arbitration, “the limitation period shall cease to run”; “arbitral proceedings shall be deemed to commence on the date on which a request that the claim in dispute be referred to arbitration is delivered at the habitual residence or place of business of the other party.”

The Convention does place an outer limit for the tolling of the limitation period through the above provisions. Article 23 states that “notwithstanding the provisions of this Convention, a limitation period shall in any event expire no later than ten years from the date on which it commenced.”

Associated limitation periods vary greatly from country to country and from cause of action to cause of action. Two common statutes of limitation periods are generally provided for breach of warranty and products liability claims. European Union law provides for an extended ten-year statute of limitation for products liability claims. In comparison, the limitation period for warranty claims is two years starting from the date of delivery.

Chapter Summary

- 1 The Convention on Contracts for the International Sale of Goods (CISG) has been the most successful attempt at the unification of international sales law. However, it is limited in scope, leaving numerous areas of contract law to be decided under domestic or national sales laws. Areas such as validity of contracts, specific performance, and products liability are not covered by the CISG.
- 2 The CISG makes it easy to form contracts because of a lack of formality requirements. For example, a written contract is not required; oral contracts are fully enforceable. Also, the CISG has an open evidence regime where the existence of a formal written contract does not prevent other evidence, including witness testimony from being used to determine the “actual” contract.
- 3 The CISG adopted the subjective theory of contract (actual party intent) as the principal rule of contract interpretation, but also adopts the objective theory of contract (reasonable person standard) if the evidence does not support a finding of subjective intent.
- 4 The CISG adopts offer–acceptance rules similar to those found in American common law except for the CISG’s rejection of the common law’s mailbox (dispatch) rule in favor of the civil law’s receipt rule. So under the CISG, a contract is formed when the acceptance is received by the offeror.
- 5 In contract interpretation, the courts or arbitral tribunals will often look at a number of sources to ascribe meaning to the contract. If the contract is clearly written many courts will not look any further in deciding the contract dispute. If the contract is ambiguous or is missing a term, courts will look to prior dealings between the contracting parties, as well as evidence taken from the subsequent performance of the contract (course of performance). Finally, if the meaning of the contract is unclear, courts will look to business customs and trade usage to clarify the ambiguity or to fill in a gap in the contract.
- 6 Under the CISG, the buyer of goods has a duty to inspect the goods promptly after their delivery and to give immediate notice of any nonconformity (defects) in the goods to the seller. If the buyer delays in performing these duties it will lose the right to sue for damages due to the defects in the goods. Upon receiving the notice of nonconformity, the seller will have a reasonable time to “cure” the defects (repair or replace the defective goods). The delivery of defective goods does not give the buyer the right to reject the goods unless the defects are considered to be a fundamental breach of the contract.
- 7 The CISG has two concepts not found in American (common law) contracts—*nachfrist* notice and the price reduction remedy. *Nachfrist* notice allows either party to request a time extension for performing past the deadline set in the contract. The seller may request additional time to deliver the goods and

the buyer may request additional time to make payment. The party receiving a reasonable *nachfrist* request must give the additional time unless they have a commercially viable reason for denying the request. Failure to perform before the expiration of the *nachfrist* period of time is deemed to be a fundamental breach, which allows the non-breaching party to avoid (terminate) the contract and sue for damages.

- 8 CISG warranty law is identical to the rules set out in the American UCC. Unless disclaimed in the contract, goods are sold with the implied warranty of merchantable quality and the implied warranty for a particular purpose. The difference between the two warranties is the first one relates to a guarantee that the goods will serve their ordinary purpose (a toaster should be able to toast bread), while in the second one the buyer relies on the judgment and skills of the seller to provide a product that will serve the buyer's particular purpose (a toaster that also acts as an oven).
- 9 The CISG provides that the non-breaching party may collect all "foreseeable" damages caused by the breach of contract including expenses incurred, lost profits, incidental expenses, and foreseeable consequential damages. The non-breaching party has a duty to avoid or mitigate damages if it is reasonable to do so. If a party fails to mitigate then the damages that could have been avoided, although caused by the breach, would not be collectable.
- 10 Excuse is the concept that a party should be relieved of liability for breaching a contract if the breach was caused by an unforeseeable event, such as an Act of God (natural disasters). The common law recognizes the excuses of impossibility (force majeure) and frustration of purpose. Article 79 provides an excuse known as "impediment." The factors usually applied in a court finding an excuse include: (1) the event that caused the breach was not "foreseeable" at the time of contract formation; (2) avoiding or preventing the event from occurring was beyond the control of the breaching party; and (3) it would be unreasonable to expect the breaching party to overcome the impediment (undue burden).

Key Terms

Acceptance	Hardship Clause	Plain Meaning Rule
Additional Term	Impediment	Prior Dealings
Adequate Assurance	Implied Warranty for a Particular Purpose	Products Liability
Anticipatory Breach	Implied Warranty of Merchantability	Ratification
Battle of the Forms	International Customary Law	Reasonable Person Standard
Bilateral Contract	Jurisdiction	Rejection
Boilerplate Terms	<i>Lex Mercatoria</i>	Revocation
Choice of Law Clause	Limited Express Warranty	Right to Cure
Computer Software Sales	Mailbox Rule	Specially Manufactured Goods
Conflict of Law Rules	Merger Clause	Standard Terms
Consequential Damages	Mirror Image Rule	Statute of Frauds
Contract Formation	Mixed Sale	Totality of the Circumstances
Convention on the Limitation Period in the International Sale of Goods	<i>Nachfrist</i> Notice	Trade Usage
Course of Performance	Objectively Unforeseeable	Undue Hardship
Disclaimer	Objective Theory of Contract	Uniform Commercial Code (UCC)
Doctrine of Frustration	Offer	Unilateral Contract
Doctrine of Impossibility	Offeree	United Nations Convention on Contracts for the International Sale of Goods (CISG)
Doctrine of Impracticability	Offeror	Virtual Goods
<i>Force Majeure</i>	Parol Evidence Rule	Written Confirmation Rule
Four Corners Analysis	Place of Business	

Chapter Problems

- 1 Compare the UCC's treatment of anticipatory repudiation and adequate assurance in 2-609 and 2-610 with the CISG's treatment in Articles 71–73. Can you find any significant differences?
- 2 In many transactions involving technology transfer, the contract provides for the sale of both goods and services. Does the CISG apply to such contracts?
- 3 How do courts determine which national laws apply in a given case?
- 4 Section 2-205 of the UCC provides an exception to the rule that an offeror is the “master of the offer” or that he has a right to revoke the offer at any time. It provides that “an offer given by a *merchant* in a *signed writing* which gives *assurance* that it will be held open is not revocable, but in no event may such period of irrevocability exceed three months.” The CISG's firm offer rule is found in Article 16. It provides that an offer cannot be revoked “if it indicates that it is irrevocable or if it was reasonable for the offeree to rely on the offer being irrevocable and the offeree has acted in reliance on the offer.” Do you see any significant differences between these two versions of the firm offer rule? Which version is broader? Why?
- 5
 - a As a seller and exporter of goods you are negotiating a long-term (three-year) installment contract. Because of the length of the contract, an open price term needs to be negotiated. Write a clause that anticipates the risks involved in entering a long-term supply contract. What cost factors should be described in detail? Also, how would one interrelate the open price term with a *force majeure* clause?
 - b You are negotiating a contract for the shipment of goods from Miami to the Middle East. The risks and costs of the shipment will be yours to the point of destination. Draft a *force majeure* clause. What events would you want to be considered as *force majeure*? Should some occurrences provide for an excuse (termination) and others for suspension?
 - c In a “battle of the forms” situation the additional terms in the acceptance often become a part of the contract. Assuming that you are the offeror, draft language for your offer that would preclude those additional terms from entering the contract. Assuming that you are the offeree, draft a clause for your acceptance that would make it clear that there is no contract unless it is on the terms of the acceptance (counteroffer).
- 6 A business manager corresponds with numerous contacts in the international business world. She sends letters and faxes to agents, customers, suppliers, distributors, lenders, and many others. Most U.S. businesspersons have been educated to believe that they would expose their companies to liability if and only if they enter into a formal written contract. The formal written contract is a product of the company's lawyers. They are also aware that under the UCC's statute of frauds they are not liable for oral promises. They further (incorrectly) rationalize that the statute of frauds requires a fully negotiated, written agreement signed by both parties. Therefore, they often say or write things aimed at encouraging another party to take some action. They say things and write letters under the assumption that they would not be held liable until they enter a formal agreement. How have these assumptions changed with the enactment of the CISG? Can businesspersons be held liable for promises or assurances made in simple business letters? How can a manager avoid such unintended liability?
- 7 The European Union has a directive pertaining to warranties in consumer transactions. Compare the selected provisions of Directive 99/44/EC with the warranty provisions found in the UCC and CISG. Note that the European word for “warranty” is “guarantee.”

Internet Exercises

- 1 Review how Islamic Law deals with commercial transactions. See <http://www.oxfordislamicstudies.com/article/opr/t236/e0156> and http://www.islamic-finance.com/item13_f.htm.

- 2 Select a country and research its sales law using the Cornell Law School Legal Information Institute at <http://www.law.cornell.edu>. Click on “Get the Law” at the top; then click “Law by Jurisdiction” on the drop down menu and then click on “World Law” on the second drop down menu.

Other Internet Sources

Case and arbitral law on the CISG: <http://www.cisg.law.pace.edu>.

Cornell Legal Information Institute—U.S. conflict of law rules: <http://www.law.cornell.edu/topics/conflicts.html>.

United Nations Commission on International Trade Law (UNCITRAL) (foreign case law on CISG or CLOUT): http://www.uncitral.org/uncitral/en/case_law.html.

UNIDROIT (International Institute for the Unification of Private Law): <http://www.unidroit.org>.

Notes

- 1 164 F. Supp. 2d 1142 (N.D. Cal. 2001).
- 2 See Larry A. DiMatteo, “The CISG as Source of International Customary Law,” American Arbitration Association, *Dispute Resolution Journal* 75 (1998).
- 3 148 F.3d 649 (7th Cir. 1998).
- 4 See Marcus Larson, “Applying Uniform Sales Law to International Software Transactions,” 5 *Tulane Journal of International and Comparative Law* 445 (1997).
- 5 914 P.2d 682 (Or. Sup. Ct. 1996).
- 6 993 F.2d 1178 (5th Cir.1993).
- 7 *Reardon Smith Line, Ltd. v. Yngvar Hansen-Tangen* [1976] 1 W.L.R. 989, 996 (Eng. H.L.).
- 8 See generally Larry A. DiMatteo, “The Counterpoise of Contracts: The Reasonable Person Standard and the Subjectivity of Judgment,” 48 *South Carolina Law Review* 293, 338–341 (1997).
- 9 General Court of Stuttgart, 3 KfH 97/89, CLOUT Case No. 4 (Case Law on UNCITRAL Text.). (CLOUT is a reporting service accessible through the United Nations document services.)
- 10 UCC § 2-605, Comment 1 (1990).
- 11 156 Eng. Rep. 145 (1854).
- 12 947 F.2d 627 (2nd Cir. 1991).
- 13 Theo Rauh, “Legal Consequences of *Force Majeure* under German, Swiss, English, and United States’ Law,” 25 *Denver Journal of International Law and Policy* 151 (1996).
- 14 548 F. Supp. 1018 (E.D. Louisiana 1982).
- 15 782 F.2d 314 (1985).
- 16 ICC Publication No. 421, “*Force Majeure* and Hardship,” (1985).
- 17 William F. Fox, Jr., *International Commercial Agreements: A Primer on Drafting, Negotiating and Resolving Disputes* 145 (2nd ed. 1992).

Part V

EXPORTING, IMPORTING, AND TRADE
FINANCE



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TRANSPORT OF GOODS

In transporting goods throughout the world, a number of different types of **common carriers** are utilized. A common carrier is a company that contracts with the public for transportation of goods or persons; commercial airlines, overnight courier services, and international shipping lines are all examples of common carriers. Each type of common carrier or carriage contract is governed by its own **unimodal transport convention** or by a **multimodal transport convention**. The most important international transport conventions are listed in Table 13.1: *Doing Business Internationally*: “International Transport Conventions,” which also shows the limited liability protection provided to the common carriers.

The application of different carriage liability regimes in an international transport of goods transaction is potentially overwhelming. The leg of transport (land, rail, ocean) in which the loss-inducing event occurs determines the convention to be applied. Determining liability is further complicated by the existence of different legal regimes for a given mode of transport. For example, in ocean carriage there are three alternative legal regimes—**Hague**, **Hague-Visby**, and the **Hamburg Rules**. If a loss is sustained during an ocean voyage, then it must be determined which ocean carriage convention is applicable.

The most established and important of the international carriage conventions is the Hague Rules.¹ The Hague Rules have been enacted into law in the United States as the **Carriage of Goods by Sea Act (COGSA)**. Unless stated otherwise, the Hague Rules and COGSA will be used interchangeably in this chapter. Most international transport of goods necessarily includes ocean carriage, and despite the increased use of multimodal transport documents, the **ocean bill of lading** remains the paramount title document. This chapter will focus on the legal regime instituted by the Hague Rules. The chapter concludes with a review of the related topic of marine insurance. We will first discuss briefly the premier air carriage convention—the **Warsaw Convention**.

Air Waybill and the Warsaw Convention

As a contract of carriage, the **air waybill** incorporates by reference the pertinent international carriage convention, namely the Warsaw Convention. Like the Hague Rules, the Warsaw Convention limits liability for the common carrier. The standard terms and conditions of the air waybill generally state that the liability limitation is “250 French gold francs per kilogram or approximately \$20 per kilogram.” The Warsaw Convention shares numerous similarities with the Hague Rules. For example, it allows for the extension of coverage to other parties involved in the carriage through a Himalaya clause. It states that: “any exclusion or limitation of liability applicable to the carrier shall apply to the benefit of the carrier’s agents, servants, and representatives and any person whose aircraft is used by carrier for carriage.”

Sea Waybill: There are different types of waybills: air waybill, inland waybill, and the seaway bill. The inland waybill can also include rail waybill. Waybills are not documents of title as is the ocean bill of lading. They are also not negotiable (transferable) as is the negotiable (order) ocean bill of lading. Waybills are simply contracts between the shipper and the common carrier and serve as proof of delivery of the goods to the common carrier. The seaway bill shows that the goods

are “on board” the ship, but since it is not a title document, it need not be presented to the common carrier in order to take delivery of the goods. This often allows the buyer to obtain the goods sooner since it is not waiting for delivery of an ocean bill of lading.

Table 13.1 Doing Business Internationally: International Transport Conventions

<i>Name</i>	<i>Type of Transport</i>	<i>Description</i>
Warsaw Convention	Air	Liability Caps: \$75,000 per person; \$400 per luggage (\$1,400 within U.S.)
Montreal Accord	Air	Unlimited Liability if Harm Due to Gross Negligence
Hague Rules	Ocean	\$500 per package limitation
Hague-Visby Rules	Ocean	\$1,000 per package limitation
Hamburg Rules	Ocean	
International Convention Concerning the Carriage of Goods by Rail (CIM Convention)	Railway	17 units of account per kilogram Wastage in transit: carrier not liable for 2 percent reduction of liquids or moist goods and 1 percent waste in dry goods items
Convention on the Contract for the International Carriage of Goods by Road (CMR)	Truck	25 gold francs per kilogram of gross weight short
UNCTAD/ICC Rules for Multimodal Transport Documents 1991	Multimodal	8.33 SDR per kilogram

The carrier is also protected from most claims of material deviation. The Convention states that “carriers may substitute alternative carriers or may without notice and with due regard to the interests of the shipper substitute other means of transportation. Carrier is authorized to select the routing or to change or deviate from the routing shown on the face of the air waybill.” In the area of notice of damage, the consignee or person entitled to take delivery must promptly inspect the goods. He then must make a written complaint “of visible damage to the goods, immediately after discovery of the damage and at the latest within 14 days from receipt of the goods.” The Convention provides for a two-year statute of limitation for the filing of claims.

International Ocean Carriage Conventions

Liability of common carriers is fixed by a combination of international conventions and national laws. National laws define issues of title and negotiability, while the international conventions impose the minimum duties of the carriers and provide limits to carrier liability. This was not always the case. Carriers, at one time, were able to shield themselves from liability by incorporating broad limitation of liability or **exculpatory clauses**. After many disputes with shippers, a compromise on issues of liability, known as the Hague Rules, was adopted in 1924. The Hague Rules established a number of carrier responsibilities such as the requirement to undertake due diligence in providing a seaworthy ship, to not deviate materially from the carriage contract, and to provide shippers with the opportunity to declare a higher value for their goods. In return, the shipping companies are provided a limitation of liability to cap their potential liabilities, along with a number of exemptions from liability.

There are three international conventions that regulate the liability of common carriers in the international transport of goods by sea: the Hague Rules, the Hague-Visby Rules, and the Hamburg Rules. There was, however, a predecessor to these international conventions—the U.S. **Harter Act of 1893**.² The primary objective of the Harter Act was to prohibit clauses whereby carriers attempted to eliminate their liability for acts of negligence. The Harter Act prohibited the enforcement of broad exculpatory clauses incorporated into the standard bills of lading by the shipping industry. It did not, however, attempt to regulate the relationships between carriers and shippers comprehensively. The Harter Act remains in force for goods shipped from one U.S. port to another U.S. port.

The Hague-Visby rules updated the Hague rules, but some countries, including the United States, have failed to ratify the update. The liability of the carrier and associated companies is directly affected depending on which version is applied. Under the Hague-Visby rules, the limit of liability is significantly increased. The Hamburg Rules are more pro-shipper than the Hague or Hague-Visby Rules. However, carrier liability protections are automatically extended to the servants or third-party contractors of the carriers under the Hamburg Rules.

The *Prima U.S., Inc. v. Panalpina, Inc.* Addiriyah case illustrates a number of points. First, it provides an introduction to the different third parties involved in the international shipment of goods, including common

Prima U.S., Inc. v. Panalpina, Inc.

223 F.3d 126 (2d Cir. 2000)

McLaughlin, Circuit Judge. The Westinghouse Electric Corporation (Westinghouse) contracted in writing with Panalpina, Inc. (Panalpina), a “freight forwarder,” for the transportation and shipment of an electric transformer from the manufacturer in Italy to the ultimate consignee, the 3M Corporation in Iowa. Panalpina, as freight forwarder, was to oversee all of the transportation for the transformer, both on land and over sea. Panalpina’s obligations under the contract included ensuring that the transformer was properly secured and lashed onto a flat-rack for ocean shipment. As is the industry custom, Panalpina did not issue a bill of lading for the shipment.

Pursuant to the standard terms and conditions listed on the reverse side of its contract, Panalpina undertook to exercise “reasonable care” in the selection of those who would actually carry, store, or otherwise handle the goods. The standard terms also limited Panalpina’s liability for losses to \$50 per shipment, and they disclaimed liability for all consequential or special damages in excess of this amount. These were the same terms utilized in the prior ten-year course of dealing involving more than 1,000 transactions between Westinghouse and Panalpina. When the time came to ship the transformer, Panalpina arranged for it to be picked up at a factory in Melegano, Italy, and brought to the Port of Genoa for an ocean trip.

In Genoa, Panalpina hired Ligure Toscano, a customs broker, to coordinate the movement of the transformer through the Genoa Port. Because the transformer was oversized, it had to be secured to a forty-foot “flat-rack” container for ocean shipment. Through Toscano, Panalpina hired CSM, a local stevedore, to load the transformer onto the appropriate container, and to lash it securely for the trip. The transformer, on its flat-rack, was loaded aboard the M/V *Addiriyah* for the voyage to the United States.

During the ocean voyage, the M/V *Addiriyah* encountered heavy seas and the transformer, which CSM had negligently lashed to its flat-rack, broke loose, crushing a laser-cutting machine owned by Prima (U.S.A), Inc. (“Prima”). Prima, via its subrogated insurer, filed a

complaint against Westinghouse and Panalpina. Prima sought damages for the loss of its laser. Westinghouse brought a third-party action for indemnification against Panalpina. The district court went on to find Panalpina liable to Westinghouse, in indemnity. Panalpina now appeals, challenging the district court’s decision that it must indemnify Westinghouse for CSM’s negligent actions. Panalpina asserts that it acted only as a freight forwarder, and hence, should not be made to indemnify Westinghouse. Panalpina was a freight forwarder, not a carrier.

The job of a “non-vessel operating common carrier” (NVOCC) is to consolidate cargo from numerous shippers into larger groups for shipment by an ocean carrier. An NVOCC issues a bill of lading to each shipper. If anything happens to the goods during the voyage the NVOCC is liable to the shipper because of the bill of lading that it issued. A freight forwarder like Panalpina, on the other hand, simply facilitates the movement of cargo to the ocean vessel. The freight forwarder secures cargo space with a steamship company, gives advice on governmental licensing requirements, proper port of exit and letter of credit intricacies, and arranges to have the cargo reach the seaboard in time to meet the designated vessel.

Unlike a carrier, a freight forwarder does not issue a bill of lading, and is therefore not liable to a shipper for anything that occurs to the goods being shipped. As long as the freight forwarder limits its role to arranging for transportation, it will not be held liable to the shipper. By analogy, Panalpina was hired to act as a “travel agent” for the transformer: it set things up and made reservations, but did not engage in any hands-on heavy lifting. Of course, a party that calls itself a freight forwarder might in fact be performing the functions of a carrier in which case function would govern over form. But the burden of demonstrating any deviation from what freight forwarders normally do in the maritime context must rest, and heavily so, on the party who would show such deviation. Moreover, when a freight forwarder selects someone to perform transportation services, that selection fulfills the forwarder’s obligations

in the absence of proof that the selection itself was negligent. We REVERSE the district court's order that Panalpina indemnify Westinghouse.

Case Highlights

- The “non-vessel operating common carrier” (NVOCC) consolidates cargo from numerous shippers into larger groups for shipment by an ocean carrier.
- Unlike a carrier, a freight forwarder does not issue a bill of lading and is not liable for damage to the goods while in the possession of a carrier.
- The freight forwarder is liable if it negligently selects a third party, such as a common carrier or customs broker, who proves to be incompetent.



Image 13.1 Loading of a Cargo Ship.

Source: Stan Shebs at Wikimedia Commons.

carriers, stevedores, freight forwarders, non-vessel operating common carriers, and the custom brokers. Second, it analyzes the importance of being designated a common carrier under the above carriage conventions, along with the potential liabilities of the freight forwarder.

Hamburg Rules

The Hamburg Rules (1978 UN Convention on Carriage of Goods by Sea) provide an alternative to the long-established Hague Rules. The impetus for the creation of the Hamburg Rules came from the developing world, who saw the Hague Rules as favoring the developed countries. The Hamburg Rules should not be disregarded since it

has come into force in 34 countries, including many from Africa. There are 19 members of the Hamburg Rules from Africa, but it also includes some countries from Europe (Austria, Czech Republic, Georgia, Hungary, and Romania), the Middle East (Jordan, Lebanon, Syria), South America (Chile, Paraguay), and the Caribbean (Barbados, Dominican Republic, St. Vincent and the Grenadines).

The Hamburg Rules are the result of a movement to establish a modern and uniform international legal regime to govern the carriage of goods by sea. For many years, a large proportion of the carriage of goods by sea has been governed by a legal regime centered around the International Convention relating to the Unification of Certain Rules relating to Bills of Lading, adopted on August 25, 1924, at Brussels, otherwise known as the Hague Rules. It was amended in 1968; this revision is known as the Hague-Visby Rules.

The Hague Rules establish a mandatory legal regime governing the liability of a carrier for loss of or damage to goods carried under a bill of lading. They cover the period from the time the goods are loaded onto the ship until the time they are discharged. There has emerged over the course of time increasing dissatisfaction with the Hague Rules system. This dissatisfaction was based in part upon the perception that the overall allocation of responsibilities and risks achieved by the Hague Rules, which heavily favored carriers at the expense of shippers, was inequitable.

The Hague Rules cover only the period from the time the goods are loaded onto the ship until the time they are discharged from it. They do not cover loss or damage occurring while the goods are in the custody of the carrier prior to loading or after discharge. In modern shipping practice, carriers often take and retain custody of goods in port before and after the actual sea carriage. It has been estimated that most loss and damage to goods occurs while the goods are in port. In order to ensure that such loss or damage is the responsibility of the party who is in control of the goods and thereby best able to guard against that loss or damage, the Hamburg Rules apply to the entire period the carrier is in charge of the goods at the port of loading, during the carriage, and at the port of discharge.

The basis of the carrier's liability under the Hague Rules system was one of the principal concerns of the movement for reform that eventually resulted in the Hamburg Rules. While the Hague Rules provide that the carrier is liable for loss or damage resulting from his failure to exercise due diligence to make the ship seaworthy, to properly man, equip and supply the ship, or to make its storage areas fit and safe for the carriage of goods, a long list of circumstances exempts the carrier from this liability. These provisions are based upon exemption clauses that commonly appeared in bills of lading when the Hague Rules were adopted in the early 1920s. Perhaps the most significant of these exemptions frees the carrier from liability if the loss or damage arises from the faulty navigation or management of the ship, the so-called "nautical fault" exception. As a result of these exemptions, the shipper bears a heavy portion of the risk of loss of or damage to his goods. The original justifications for this liability scheme, and in particular the nautical fault exception, were the inability of the ship owner to communicate with and exercise effective control over his vessel and crew during long voyages at sea, and the traditional concept of an ocean voyage as a joint adventure of the carrier and the owner of the goods. However, subsequent developments in communications and the reduction of voyage times have rendered those justifications obsolete. The liability scheme has no parallel in the law governing other modes of transport. Moreover, it is viewed as contrary both to the general legal concept that one should be liable to pay compensation for loss or damage caused by his fault or that of his servants or agents, and to the economic concept that loss should fall upon the party who is in a position to take steps to avoid it. The Hamburg Rules effect a more balanced and equitable allocation of risks and responsibilities between carriers and shippers. Liability is based on the principle of presumed fault or neglect. That is, the carrier is liable if the occurrence that caused the loss, damage or delay took place while the goods were in his charge, and he may escape liability only if he proves that he, his servants or agents took all measures that could reasonably be required to avoid the occurrence and its consequences. This principle replaces the itemization of the carrier's obligations and the long list of his exemptions from liability under the Hague Rules, and eliminates the exemption from liability for loss or damage caused by the faulty navigation or management of the ship. The liability of the carrier under the Hamburg Rules corresponds with the liability imposed upon carriers under international conventions governing carriage of goods by other modes of transport, such as road and rail.

Sea cargo carried on deck was traditionally subject to high risk of loss or damage from the elements or other causes. For this reason, the Hague Rules do not cover goods carried on deck by agreement of the parties, permitting the carrier to disclaim all liability for such cargo. However, developments in transport and packaging techniques, and in particular containerization, have made it possible for cargo to be carried on deck with relative safety. It is common for containers to be stored on deck in modern container ships. The Hamburg Rules take these developments into account. Firstly, they expressly permit the carrier to carry goods on deck not only if the shipper so agrees, but also when such carriage is in accordance with the usage of the particular trade or as required by law. Secondly, they hold the carrier liable on the basis of presumed fault or neglect for loss, damage, or delay in respect of goods that he is permitted to carry on deck. If he carries goods on deck without being permitted to do so, he is made liable for loss, damage, or delay resulting solely from the carriage on deck, without being able to exclude that liability by proving that reasonable measures were taken to avoid the loss, damage, or delay.

Historically, sea voyages were subject to innumerable uncontrollable hazards, which frequently resulted in delays and deviations. Because of this unpredictability, the Hague Rules do not cover the liability of the carrier for delay in delivery. However, as a result of modern shipping technology, the proper charting of the oceans and sophisticated and efficient methods of navigation, voyages have become less subject to delays and more predictable. Shippers have come to rely upon and expect compliance with undertakings by carriers to deliver the goods within a specified period of time. Thus, the Hamburg Rules govern the liability of the carrier for delay in delivery in the same manner as liability for loss of or damage to the goods.

Limitation of Liability

The liability of the common carrier is limited to an amount equivalent to 835 units of account per package or other shipping unit or 2.5 units of account per kilogram of gross weight of the goods lost or damaged, whichever is the higher. The unit of account is the **Special Drawing Rights (SDR)** as defined by the **International Monetary Fund (IMF)**.

Special Drawing Rights (IMF): The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. The SDR is valued on a basket of currencies consisting of the euro, Japanese yen, pound sterling, and U.S. dollar. The value of the SDR in terms of the U.S. dollar is determined daily and posted on the IMF's web site. It is calculated as the sum of specific amounts of the four basket currencies valued in U.S. dollars, on the basis of exchange rates quoted at noon each day in the London market. The basket of currencies expanded to include the Chinese renminbi (RMB) as the fifth currency, effective October 1, 2016.

The SDR is calculated daily based on the exchange values of four currencies: euro, Japanese yen, UK pound sterling, and U.S. dollar. Table 13.2 “Calculation of SDR” shows the calculation of the value of the SDR for June 5,

Table 13.2 Calculation of SDR (June 5, 2015)

<i>Currency</i>	<i>Amount of Currency</i>	<i>Exchange Rate</i>	<i>USD Equivalent</i>
Euro	0.4230	1.12220	0.474691
Japanese Yen	12.100	124.8200	0.096940
Pound Sterling	0.1110	1.53000	0.169830
U.S. Dollar	0.6600	1.00000	0.660000
			1.401461
		USD = SDR	0.713541
		SDR = USD	1.401461

Note: In December 2015, the IMF announced that the Chinese *yuan* would be included in the “basket of currencies” that make up the SDR. For more details on the calculation see IMF at <http://www.imf.org/external/np/tre/sdr/sdrbasket.htm>.

2015. Note that the four currencies are weighted differently with the current weighting or share of the basket of currencies set at USD, 41.9 percent; euro, 37.4 percent; pound sterling, 11.3 percent; and yen, 9.4 percent. Based on the dollar value of the SDR, the per package limitation of liability of the common carrier for the loss or damage to goods would be \$1,170 ($835 \times \1.40146).

Deck Cargo

The carrier is entitled to carry the goods on deck only if such carriage is in accordance with an agreement with the shipper or with the usage of the particular trade or is required by statutory rules or regulations.

Issuance of the Bill of Lading

When the carrier takes the goods in his charge, the carrier must, on demand of the shipper, issue to the shipper a bill of lading. A person having authority from the carrier may sign the bill of lading. It is customary for the master of the ship carrying the goods signs the bill of lading on behalf of the carrier.

Contents of the Bill of Lading

The bill of lading must include the following particulars:

- a general statement of the nature of the goods, the leading marks necessary for identification of the goods, an express statement, if applicable, as to the dangerous character of the goods, the number of packages or pieces, and the weight of the goods or their quantity otherwise expressed, all such particulars as furnished by the shipper;
- b apparent condition of the goods;
- c name and principal place of business of the carrier;
- d name of the shipper;
- e consignee if named by the shipper;
- f port of loading under the contract of carriage by sea and the date on which the goods were taken over by the carrier at the port of loading;
- g port of discharge under the contract of carriage by sea;
- h number of originals of the bill of lading;
- i place of issuance of the bill of lading;
- j signature of the carrier or a person acting on his behalf;
- k freight to the extent payable by the consignee or other indication that freight is payable by him;
- l statement, if applicable, that the goods shall or may be carried on deck;
- m date or the period of delivery of the goods at the port of discharge if expressly agreed upon between the parties; and
- n any increased limit or limits of liability where agreed upon.

After the goods have been loaded on board, if the shipper so demands, the carrier must issue to the shipper an **on-board bill of lading** which, in addition to the above particulars, must state that the goods are on board a named ship or ships, and the date or dates of loading. If the carrier has previously issued to the shipper a bill of lading or other document of title with respect to any of such goods, such as a received for shipment bill of lading, it must issue the on-board bill of lading at the request of the shipper in exchange for the received for shipment bill of lading.

Carriage of Goods by Sea Act (COGSA)

The Carriage of Goods by Sea Act or COGSA³ is the U.S. domestic version of the Hague or Hague-Visby Rules. Most of the major maritime nations of the world have adopted one of these two conventions into their national laws. The U.S. COGSA is modeled after the Hague Rules; the United Kingdom's is modeled on the Hague-Visby Rules.

The application of COGSA in the United Kingdom differs from its counterpart in the United States in two fundamental ways. First, Hague-Visby Rules apply to any shipments *from* a port in the United Kingdom. This differs in application from the Hague Rules as adopted in the United States. COGSA in the United States applies to all shipments *from* and *to* U.S. ports. In the United Kingdom, COGSA does not automatically apply to shipments from a foreign port to the United Kingdom. Second, COGSA does apply to shipments *from* one port in the United Kingdom to another such port. The U.S. has a separate law, known as the Harter Act, which covers shipments from one U.S. port to another U.S. port, unless the parties expressly agree that COGSA (Hague Rules) is to be the governing law. All future references in this chapter will be to COGSA as the codified version of the Hague Rules.

COGSA applies only to shipments evidenced by a bill of lading. COGSA states that it applies only to carriage of goods by sea where the carriage contract “expressly or by implication provides for the issue of a bill of lading or any similar document.” The carriage contract is the bill of lading that is issued by either a common carrier or a charter party. A **charter party** is one who leases the entire ship from the ship’s owner. COGSA would apply if the charter party then enters into carriage contracts with third parties and issues bills of lading in conjunction with these contracts.

The period of coverage under COGSA is limited to “the time when the goods are loaded on to the time they are discharged from the ship.” Therefore, unless the bill of lading extends the period of coverage, COGSA does not cover the period of time when the goods are in the possession of the common carrier before loading and after discharge. Bills of lading generally incorporate a **marine extension** or **warehouse-to-warehouse clause** to extend the period of coverage. See Figure 13.1 *Focus on Transactions*: “Warehouse-to-Warehouse Clause.”

In addition, specialized companies, such as stevedore companies, are used by the common carrier to move the goods to and from the ship and to load and off load the goods. COGSA protection is extended to these third-party companies through the use of a **Himalaya clause**. The third party need not be specifically named in the Himalaya clause in order for the protection of a carriage convention to be extended. General language, for example, is sufficient to extend defenses under the bill of lading to stevedores. The following provision is an example of a typical Himalaya clause:

*No servant or agent of the Carrier (including every independent contractor from time to time employed by the Carrier) shall in any circumstances whatsoever be under any liability whatsoever to the Merchant (shipper). Every right, exemption, defense and immunity of whatsoever nature applicable to the Carrier shall also be available and shall extend to protect every such servant or agent of the Carrier.*⁴

The above clause was held to be sufficient to extend coverage to a stevedore company and a consultant hired to supervise the stowage of the cargo. Almost any company working in conjunction with the common carrier is extended the same COGSA protections. For example, marine terminal operators have been extended protection under a general Himalaya clause.⁵

The primary objective of COGSA is to limit the liability of the common carrier while at the same time ensuring a claim for damages by shippers. COGSA limits the liability of the common carrier to \$500 (Hague Rules) or \$1,000

<p><i>Duration:</i> This insurance attaches from the time the goods leave the warehouse or place of storage at the place named herein for the commencement of the transit and terminates either:</p> <ol style="list-style-type: none"> 1 On delivery to the Consignee’s or other final warehouse or place of storage at the destination named herein, 2 On delivery to any warehouse, whether prior to or at the destination named herein, which the assured elects to use either for: 	<ol style="list-style-type: none"> i Storage in the ordinary course of transit, or ii Allocation or distribution, or <ol style="list-style-type: none"> 3 On the expiration of 60 days after the completion of discharge overside of the goods from the overseas vessel at the final port of discharge, whichever shall occur first. This insurance shall remain in force during delay beyond the control of the assured, any deviation, forced discharge, reshipment or transshipment arising from the exercise of a liberty granted to shipowners under the contract of affreightment (carriage).
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Figure 13.1 *Focus on Transactions*: Warehouse-to-Warehouse Clause.

(Institute of London Underwriters, Clause A.)

(Hague-Visby Rules) per package. It also provides 17 exemptions that fully exempt the common carrier from all liability for damage or loss to the goods. If the losses relate to a number of enumerated duties, however, the **per package limitation** and 17 exemptions are removed, and the common carrier becomes liable for all damages. First, losses attributed to the carrier's failure to perform **due diligence** in providing a seaworthy ship. Second, the carrier commits a **material deviation**. Third, the carrier fails to provide a **fair opportunity** for the shipper to declare a value above the per package limitation.

Carrier Liability

The primary grounds for common carrier liability are outlined in a single paragraph, Section 1304(5), of COGSA. The numbers within the paragraph signify important liability issues and are explained below.

§ 1304(5):

Neither the carrier nor the ship shall in any event be or become liable for any loss or damage to or in connection with the transportation of goods in an amount exceeding \$500 per package lawful money of the United States, or in case of goods not shipped in packages, per customary freight unit (2), or the equivalent of that sum in other currency, unless the nature and value of such goods have been declared by the shipper before shipment and inserted in the bill of lading. This declaration, if embodied in the bill of lading, shall be prima facie evidence, but shall not be conclusive on the carrier. In no event shall the carrier be liable for more than the amount of damage actually sustained.⁶

The carrier's liability under COGSA is determined in one of two ways. First, an amount (not to exceed \$500) per package multiplied by the number of packages listed or described in the bill of lading (1). Second, an amount declared by the shipper on the bill of lading (3). The per package limitation is the default provision meaning that if the shipper fails to declare a higher amount then the carrier's liability is automatically capped at \$500 per package.

Some types of goods, however, are not packaged for shipment. There are, therefore, no packages for purposes of calculating the carrier's liability. COGSA provides an alternative in such cases known as the **customary freight unit** or **CFU** to determine the number of packages. For example, in *Caterpillar Overseas v. Marine Transport, Inc.*, the court determined that each tractor in a shipment of tractors was a CFU.⁷ Other examples are measurements used for bulk goods, such as tons (coal), cubic yards (wheat), or barrels (oil). It is important to note that the \$500 per package amount is an upper limit. If the goods have a value of less than \$500 per package, then the carrier is liable only for the lesser amount. The same is true in the case where the shipper declares a higher value. If the value of the goods is less than the amount declared, then the carrier is liable only for the true value. COGSA provides that the actual loss figure is to be determined based upon the value of the goods "at the time and place of discharge." It then offers three sources for the determination of value: commodity exchange price, current market price, or "the normal value of goods of the same kind and quality."

As discussed above, the cap of \$500 per package or CFU is overridden by any higher value declared by the shipper on the bill of lading. Implied in this right of the shipper to declare a higher value is a correlative duty of the carrier to provide an opportunity for such a declaration. The carrier is liable for an undeclared higher value if it failed to give the shipper "a *fair opportunity* to choose a higher liability by paying a corresponding greater charge."⁸ Common carriers generally honor their duty to provide fair opportunity to declare a higher value by providing notice and a space to declare a higher value on the face of the bill of lading. Although good practice, some courts have held that placing a space on the face of the bill of lading is not required. Language found in the fine print on the back of the bill of lading form may be sufficient.⁹

Carrier's Duties

COGSA not only restricts the common carrier's ability to limit its liabilities, but also sets out a number of mandatory responsibilities. COGSA lists a number of duties of the carrier that pertain to its issuance of bills of lading.

First, there is a general duty on the carrier to issue a bill of lading when receiving goods from the shipper. Second, the bill must include basic information, including “leading marks” provided by the shipper for the identification of the goods; the number of packages or pieces, or the quantity, or weight as furnished by the shipper; and the apparent order or condition of the goods. Any such statements regarding the above requirements shall be *prima facie* evidence that the goods were so delivered to the carrier. Thus, the carrier becomes a guarantor of the information provided by the shipper and placed on the bill of lading.

If the goods delivered are not in the condition as stated on the bill of lading or there is a **shortage** as to quantity, then the shipper or the party receiving goods meets its burden of proof by providing the bill of lading as evidence. However, a party’s right to make claim against the carrier is limited by two procedural requirements. First, the receiving party must give notice of loss either at the port of discharge or at the time of receiving the goods from the carrier. If the loss is not apparent at the time of receiving the goods, then notice must be given in writing within three days. Failure to give notice is *prima facie* evidence that the goods received were as indicated on the bill of lading. Upon the giving of the required notice of loss, COGSA provides a one-year **statute of limitations**. The party suffering a loss must commence suit within one year of the delivery of the goods.

COGSA prohibits any attempts by the carrier to insert into its bill of lading more restrictive procedural requirements or attempts to limit its duties and liabilities. COGSA states that: “any clause in a contract of carriage relieving the carrier from liability shall be null and void.” The question has arisen whether an arbitration clause in the bill of lading is subject to challenge under this limitation. The Supreme Court in *Vimar Seguros y Reaseguros v. M/V Sky Reefer*¹⁰ found that an arbitration clause in the bill of lading was not subject to attack under COGSA. The Court referred to the **Federal Arbitration Act (FAA)**¹¹ for the general premise that arbitration is a favored means of dispute resolution in the United States. Regarding COGSA, it held that an arbitration clause is not to be considered as a type of disclaimer or limitation of liability that is generally prohibited under COGSA.

The arbitration clause was held not to lessen the liability of the common carrier by increasing the costs of obtaining relief. The added cost argument pertained not so much to the fact that arbitration was mandated but that the arbitration was to be held in Tokyo, Japan. The lessening of liability argument was not strengthened by the fact that both Japanese and American laws were based upon the Hague Rules. The Court did outline one exception to the enforcement of arbitration clauses in bills of lading. This would be where a forum selection clause and a choice of law clause are used in tandem to prevent a shipper from pursuing its statutory remedies under COGSA.

A clause that limits carrier liability that is generally recognized by the courts is the **force majeure clause**. The *force majeure* clause is a standard clause in a marine contract exempting the parties from liability for non-performance resulting from a condition beyond their control, such as government interference, wars, and “Acts of God.” The next part of the chapter will analyze more fully the carrier’s duty to shippers and its liabilities for failing to perform those duties.

Seaworthiness

The common carrier must satisfy two general duties in order to gain the protections of COGSA. First, it must perform due diligence in preparing the ship. Second, the ship must be seaworthy at the time of departure. The due diligence undertaking is to be performed before the ship departs from the port of shipment. The **seaworthiness** determination is done at the time of departure. In the event that the ship becomes unseaworthy after it leaves the port of shipment, the common carrier remains protected under COGSA.

Four parameters must be met in order for a ship to be considered seaworthy under COGSA. First, the ship used must be appropriate for the type of carriage. Factors in making this determination include the type of goods being transported and the anticipated route of transit: a ship that may be seaworthy for lake or river travel may be unseaworthy for ocean carriage; a ship that may be seaworthy for the carriage of containers may be unseaworthy for the shipment of bulk goods. Second, the ship must be properly equipped for the “reception, carriage, and preservation” of the goods. Thus, all mechanical devices such as fire suppression equipment and refrigeration units must be properly maintained and functioning.



Image 13.2 Disaster at Sea.

Source: New Zealand Defence Force, Wikimedia Commons.

Third, the common carrier must man the vessel with a competent crew, properly trained to operate the ship and its equipment. Fourth, the carrier must “properly and carefully load, handle, stow, keep, and discharge the goods carried.” Proper **stowage** varies according to the types of goods being transported. Goods that are susceptible to motion must be properly lashed or secured in the hull of the ship. The *Manifest Shipping* case that follows focuses on two elements of seaworthiness—ship’s equipment and competency of the crew.

Manifest Shipping v. Uni-Polaris Insurance Co.

1 Lloyd’s L. R. 651 (Q.B. 1995)

Justice Tuckey. *Star Sea* had an engine room and cargo holds that were protected from fire by a full flood carbon dioxide extinguishing system. It also had an electrically powered fire pump in the engine room and an emergency fire pump in the forepeak. While in transit from Brazil with a load of bananas she was inspected by the Belgian port authority and found to have a nonworking emergency fire pump. The chief engineer in repairing the pump cut the suction pipe. The emergency fire pump was repaired but the cut pipe was never repaired. On the return trip to South America a fire started in the engine room. The shipowner filed a claim under its marine insurance policy for a constructive total loss. The insurance company denied liability

contending that the ship had been sent to sea in an unseaworthy state. The lower court held that the cut pipe made the vessel unseaworthy; however, as the fire involved electrical cables, the fact that the emergency pipe was not working would not have materially affected the spread of the fire.

The present court holds that the ship was unseaworthy on another matter. The ship was unseaworthy pertaining to this claim because of the incompetence of the ship’s master. The master’s conduct demonstrated a massive ignorance of the working of the carbon dioxide fire suppression system. Furthermore, this incompetence is attributable to the ship’s owner because it looked to the maintenance of the fire equipment and the training of the master with a blind eye.

The essence of this allegation is that the master was unaware of the need to use the carbon dioxide system as soon as he realized that the fire could not be fought in any other way. Instead the system was not discharged until at least two and one-half hours after the fire had started. I have no doubt that this was negligent, but does it indicate that the master was incompetent so as to render the ship unseaworthy? I accept that just because the master made a mistake or mistakes, it does not follow that he was incompetent. In fact, given the master's years of experience, I do not doubt his general competence. However, since he did not undergo fire training when he was first certified his competence regarding the particular fire suppression system is in doubt. The master's conduct demonstrates a

massive ignorance of its essentials, which can only be characterized as incompetence. Due to this incompetence I find that the vessel was unseaworthy. Judgment is REVERSED.

Case Highlights

- Under COGSA, for a ship to be seaworthy its equipment must be in good working order and the crew must be competent in operating the equipment.
- A nonoperational fire suppression system will generally render a ship unseaworthy.
- A ship's captain or master may possess general competence but still be judged incompetent regarding the operation of the ship's equipment.

Per Package Limitation

Section 1304(5) of COGSA, as discussed earlier, provides a liability limitation to the common carrier of \$500 per package. An issue often litigated is what is a "package" for purposes of calculating damages? Congress did not define the term *package* in COGSA. Clearly, cargo fully boxed or crated is a "package," particularly "where the mode of packaging conceals the identity of the goods being shipped." Similarly, freestanding cargo not enclosed in a box or crate clearly constitutes "goods not shipped in a package." But, what about cargos where some preparation for transportation has been made, but the mode of packaging does not completely conceal or enclose the goods? The answer is not always obvious.

In *London Underwriters v. Sea-Land Service, Inc.*,¹² the court held that a yacht shipped in an on-deck cradle constituted a package. In comparison, another court held that a transformer to which a wooden skid was attached did not constitute a package. A package is likely to be presumed if the cargo fits a plain, ordinary definition of "package." In short, if the cargo could not have been simply dumped in a hold, then it is likely to have been carried with some sort of packaging. Also, most courts will give great weight to the designation of the cargo as packages in the bill of lading.

A common problem is the existence of a number of different "packages" for a court to choose in assessing COGSA damages. The different means of quantifying a shipment of goods may stem from how the goods are packaged or how they are described in the bill of lading. In *Sony Magnetic Products Inc. v. Meriventi*,¹³ Sony packed a standard cargo container with video cassette tapes. Sony first placed the tapes into 1,320 cardboard cartons and then strapped the cartons onto 52 wooden pallets. The carrier issued Sony a bill of lading with the following description: "Description of Packages and Goods, 1 × 40 foot container STC [said to contain]: 1,320 Ctns." The bill of lading did not reserve space for designating the value of the cargo, but the attached export certificate showed a value of \$424,765.44. The court found that each of the 1,320 cartons was a "package" for purposes of COGSA, capping liability at \$660,000, and then awarded \$424,765.44, the actual damages sustained by Sony as evidenced by the invoice value of the tapes.

Sony Magnetic Products Inc. v. Meriventi

863 F.2d 1537 (11th Cir. 1989)

Kravitch, Circuit Judge. Sony Magnetic Products, Inc., of America contacted Page & Jones, a freight forwarder

with offices in Mobile, Alabama, to arrange for the transportation of a container of video cassette tapes to England.

Page & Jones reserved space for Sony's cargo with Atlantic Cargo Services on board the *Finnhawk*. Sony packed its cargo of video cassette tapes into a standard shipping container, measuring 40 feet long by 8 feet wide by 8 feet high. As the *Finnhawk's* deck crane was lifting the container of Sony's tapes up to the vessel's cargo deck, the hydraulic motor of the crane exploded causing the container to drop approximately 60 feet to the concrete loading deck below.

The first issue on appeal is whether the district court properly imposed liability on the defendants under COGSA for the damage to Sony's video cassette tapes. A shipper establishes a *prima facie* case under COGSA by proving that the carrier received the cargo in good condition but unloaded it in a damaged condition. A carrier can rebut a shipper's *prima facie* case by establishing either that it exercised due diligence to prevent the damage to the cargo by properly handling, stowing, and caring for it in a seaworthy ship or that the harm resulted from one of the excepted causes listed in section 1304(2). If the carrier is able to rebut the shipper's *prima facie* case, the burden then shifts back to the shipper to show that the carrier's negligence was, at the least, a concurrent cause of the loss.

The defendants attempted to establish that the accident that caused the damage to Sony's cargo was the result of a latent defect in the motor of the *Finnhawk's* crane, one of the enumerated exemptions. In addition, crew members of the *Finnhawk* maintained that there had been no complaints about or problems with the crane and that it had always been properly

maintained and inspected. In pertinent part, § 1304 of COGSA provides as follows:

(2) Neither the carrier nor the ship shall be responsible for loss or damage arising or resulting from—(p) Latent defects not discoverable by due diligence. A latent defect is one that could not be discovered upon reasonable inspection or by any known and customary test.

The district court concluded, as a matter of law, that the defendants had not sustained their burden of proving that Sony's loss was caused by a latent defect. For the foregoing reasons, the judgment of the district court is **AFFIRMED**.

Case Highlights

- Often times the bill of lading is prepared by the freight forwarder, on behalf of the shipper, and submitted to the carrier for signature.
- Presenting a clean bill of lading satisfies the shipper's initial burden of proving that it had delivered cargo in good condition to the carrier.
- A carrier can rebut a shipper's *prima facie* case by establishing either that it exercised due diligence to prevent the damage to the cargo by properly handling, stowing, and caring for it in a seaworthy ship or that the harm resulted from one of the enumerated exemptions or causes.
- The carrier has a heavy burden in proving that the loss was due to a "latent defect."

Previously, the court in *Vegas v. Compania Anonima Venezolana*¹⁴ decided that an ambiguity on a bill of lading regarding the number of COGSA packages should be resolved in favor of the shipper. Like the shipper in the *Sony* case, Vegas had consolidated cartons of goods onto pallets and informed the carrier on the bill of lading of the number of individual cartons. Unlike the shipper in *Sony*, however, Vegas not only disclosed the number of cartons but also disclosed that they had been consolidated onto pallets. The *Vegas* court resolved the ambiguity, a stated number of cartons and a lesser number of pallets, on the bill of lading in favor of the shipper. It is important to note that the *Sony* court used only the value listed in the export certificate as evidence of value. It did not hold that the value of the goods listed on the attached export certificate was a declaration of a higher value for purposes of COGSA. Section 1304(5) expressly requires that any declared value be "inserted in the bill of lading."

Once it is determined that goods have been lost or damaged, the plaintiff must determine a number procedural issues. First, who has the burden of proof in proving damages and how can such proof be rebutted? Second, what parties have standing to sue the carrier? The *Polo Ralph Lauren v. Tropical Shipping* case that follows reviews these different procedural issues relevant to all claims under COGSA.

Polo Ralph Lauren, L.P. v. Tropical Shipping & Construction Co.*215 F.3d 1217 (11th Cir. 2000)*

Kravitch, Circuit Judge. This appeal centers on what recourse, if any, an owner of goods lost at sea has against the carrier when the owner of the goods is not a named party to the bill of lading. Plaintiff Polo Ralph Lauren, L. P. (“Polo”), seeks damages for cargo lost overboard while in transport with Tropical Shipping & Construction Company (“Tropical”). Polo apparently entered into a bailment contract with Drusco, Inc. (“Drusco”) for the manufacture and delivery of 4,643 pairs of pants.

Under the terms of this agreement, Polo sent fabric to Drusco in Florida, which Drusco cut and preassembled before shipping the fabric pieces to the Dominican Republic to be sewed into finished pants. Drusco entered into similar arrangements with several other clothing manufacturers and combined the pants from all of the manufacturers into two large sealed containers that it delivered to Tropical. Drusco also arranged for the return shipment of the finished trousers to Florida where it would add designer accoutrements before returning them to the manufacturers for sale to retailers.

While en route from the Dominican Republic to Florida, the container containing Polo’s cargo was lost overboard in rough seas. Polo asserted claims for breach of contract, bailment, and negligence. The district court granted the motion as to the contract claim on the ground that Polo did not have standing because it was not named in the bills of lading. The court also granted summary judgment to Tropical on the bailment and negligence claims as preempted by COGSA.

COGSA—An Exclusive Remedy

COGSA, enacted in 1936, governs “all contracts for carriage of goods by sea to or from ports of the United States in foreign trade.” The purpose of COGSA was to achieve international uniformity and to redress the edge in bargaining power enjoyed by carriers over shipper and cargo interests by setting out certain duties and responsibilities of carriers that cannot be avoided even by express contractual provision. Plaintiff states a *prima facie* claim under COGSA by demonstrating delivery of goods in sound condition to a carrier and their subsequent receipt in damaged condition. The burden then shifts to the carrier to establish that the damage was not caused by its negligence.

We conclude that because COGSA applies in this case, it provides Polo’s exclusive remedy and preempts Polo’s

tort claims. We have found no cases in which a court has allowed a tort claim to proceed when COGSA applies. Polo’s complaint therefore should have stated a single COGSA claim instead of three separate causes of action. Many courts have recognized that a COGSA claim against a negligent carrier for lost or damaged goods comprises elements of both contract, arising from the breach of the contract of carriage, and tort, issuing from the breach of the carrier’s duty of care.

Although recognizing the COGSA claim’s hybrid nature, these cases do not stand for the proposition that COGSA provides various causes of action, both contract and tort, from which a plaintiff may choose in seeking redress from a negligent carrier. Nothing in the language of COGSA or the cases interpreting it leads us to believe otherwise. We therefore conclude that COGSA affords one cause of action for lost or damaged goods. The district court properly granted summary judgment on Polo’s actions in bailment and negligence.

Polo’s Standing to Bring a COGSA Claim

The district court rejected Polo’s argument that it was a third-party beneficiary to the bills of lading and granted summary judgment. Polo is not named in the bills of lading. Contracts bind only named parties unless both parties to the contract clearly express a mutual intent to benefit a third party. This rule of strict construction applies with equal force in contracts of carriage. The third party need not be mentioned by name as long as the contract refers to a “well-defined class of readily identifiable persons” that it intends to benefit.

Polo argues that the inclusion of the “owner of the goods” in the bills of lading evinces a clear intent to benefit that class of persons. The back of the bills of lading uses the phrase “shipper, consignee, or owner of the goods” repeatedly in defining the conditions of the contract of carriage. The final clause of the bills iterates that the “Shippers, Consignees, and Owners of the goods and the Holder of the Bill of Lading” expressly agree to all its terms. Polo argues that these recurring references to the “owner of the goods” intend to benefit Polo.

In *All Pacific Trading, Inc. v. Vessel M/V Hanjin Yosun*, 7 F.3d 1427 (9th Cir.1993), the court considered a consolidated action brought by nine owners of damaged goods and their insurers. Eight of the nine plaintiffs

delivered their goods to different non-vessel operating common carriers (“NVOCCs”) who issued bills of lading to the shippers and then delivered the goods to the carrier, who in turn executed separate bills of lading with the NVOCCs. The cargo owners were not named in the bills of lading with the carrier. The court rejected the carrier’s argument that the plaintiff cargo owners lacked standing to sue because it found that the cargo owners were actual parties to the bills of lading. As with the bills of lading before us, those bills of lading contained a clause obligating the “owner of the goods” to their terms.

The bills of lading between Tropical and Drusco recurrently refer to the “owner of the goods” and specifically bind the “owner of the goods” to its terms and obligations, creating the possibility that Polo would have standing to sue as owner of the goods or as a third-party beneficiary to the bills of lading. There was sufficient evidence before the district court of Polo’s

ownership to render improvident its grant of summary judgment on Polo’s COGSA claim.

AFFIRMED in part; REVERSED in part.

Case Highlights

- COGSA governs all contracts for carriage of goods by sea to or from ports of the United States in foreign trade.
- The initial burden of proof is on the shipper to prove that the goods delivered to the carrier were in sound condition. This burden is met by providing a “clean” bill of lading. The burden then shifts to the carrier to prove that the damage was not caused by its negligence.
- A party does not have to be named in the bill of lading to have standing to sue the carrier if it is a member of a class of persons that were intended to benefit from the carriage contract.

COGSA Coverage

COGSA is more comprehensive than the Harter Act in regulating the carrier–shipper relationship.¹⁵ The Hamburg Rules are even more so. All three provide a relatively fair allocation of liability between the carrier and the shipper. There are some important differences, however, between the different carriage conventions. For example, COGSA limits the liability of the carrier to the time frame represented from “tackle to tackle” or from time of loading to time of discharge. This does not take into account the time when the goods are in the control of the carrier before the loading and after the unloading of the cargo.

The Hamburg Rules extend the period of responsibility to include when the goods are in the control of the carrier but not on the ship. Article 7 of the Hague Rules (COGSA) allows the parties to agree to extend the period of application to the period “prior to the loading, and subsequent to the discharge.” This is generally done through the insertion of a warehouse-to-warehouse clause into the bill of lading. The *Mori Seiki USA v. M/V Alligator Triumph* case reviews the “tackle to tackle” coverage of COGSA, the duty of the carrier to provide an opportunity to declare a higher value, and the use of the Himalaya clause to extend COGSA to third parties.

Mori Seiki USA, Inc. v. M/V Alligator Triumph, Mitsui Lines

990 F.2d 444 (9th Cir. 1993)

Hug, Circuit Judge. Appellant, Mori Seiki USA, Inc. (“Mori Seiki”), was the consignee of a precision lathe that was damaged while being transported from Nagoya, Japan to Houston, Texas. The lathe was damaged after it was unloaded from an ocean vessel at the Port of Los Angeles, but before it was released from the seaport. Mori Seiki filed suit in district court seeking damages from the ocean carrier (Mitsui), the ship (M/V *Alligator Triumph*), the seaport operator (Trans Pacific Container),

and the stevedore services firm, which unloaded and handled its lathe (Marine Terminals Corporation).

Applicability of COGSA after Discharge

COGSA applies to all cargo shipments carried by sea, to or from the United States. By its own terms, COGSA limits liability for cargo damage to \$500, if the damage

occurs between the time the cargo is loaded on to the ship and the time it is discharged from the ship (“tackle to tackle”). Parties to a shipping agreement, however, may contractually extend the limitation period.

The bill of lading at issue in this case stated that “with respect to loss or damage occurring during the period from the time when the Goods arrived at the sea terminal at the port of loading to the time when they left the sea terminal at the port of discharge the carrier shall be responsible for such loss or damage to the extent prescribed by the Hague Rules (COGSA).” The plain meaning of this language is that COGSA’s liability limitation would extend to the period after the lathe was discharged from the ship, but before it was released from the sea terminal. Although it is true that a bill of lading is a contract of adhesion, which is “strictly construed against the carrier,” and that “any ambiguity in the bill of lading must be construed in favor of the shipper and against the carrier,” we are not persuaded that such an ambiguity exists here. The bill of lading extended COGSA’s \$500 liability limitation to the period during which the lathe was damaged.

Extension of Liability Limitation under the Himalaya Clause

Mitsui’s bill of lading included a so-called “Himalaya clause,” which is commonly used to extend a carrier’s defenses and liability limitations to certain third parties performing services on its behalf. The district court concluded that the seaport operator and the stevedore services company were covered by the Himalaya clause in Mitsui’s bill of lading. We conclude, therefore, that the Himalaya clause extended Mitsui’s COGSA defenses, including the \$500 package liability limitation, to Marine Terminals Corporation. **AFFIRMED.**

Case Highlights

- COGSA covers only the “tackle to tackle” portion of the carriage unless contractually extended in the bill of lading.
- The Himalaya clause is commonly inserted in the freight contract to extend a carrier’s defenses and liability limitations (COGSA) to third parties performing services on its behalf, such as a stevedore company.

Carrier is defined more broadly by the Hamburg Rules. They define carrier as “any person by whom a contract of carriage of goods by sea has been concluded with a shipper.” By not referring to “carrier,” as COGSA does, the Hamburg Rules apply to parties such as freight forwarders and terminal or non-vessel common carriers. COGSA applies only to shipments covered by a bill of lading. In contrast, Hamburg Rules apply to any contracts of carriage by sea such as straight or nonnegotiable bills of lading and electronic documents.

In addition, the Hamburg Rules provide specific rules for carriage above deck, while the Hague Rules exclude deck carriage from its application. COGSA does permit the parties to agree to above-deck carriage. This is done through the incorporation of a **clause paramount** into the bill of lading. The burden of proof is on the shipper under COGSA to prove that any loss was due to the fault of the carrier. The burden is satisfied generally by the presentment of a *clean* bill of lading. In contrast, carrier fault is presumed under the Hamburg Rules. Article 5 of the Hamburg Rules states that “the carrier is liable for loss, damage, or delay that occurred while the goods were in its charge.” It then expressly states that “as a rule, the burden of proof rests on the carrier.”

A still unresolved issue is how best to deal with combined or **multimodal transport** contracts. The Hague Rules and COGSA were enacted prior to the advent of **containerization**. Containerization allows a single container to be used in different modes of transit.¹⁶ A container can be attached to a truck, placed on the bed of a railroad car, and loaded on to a ship. The current approach is the recognition that the different unimodal conventions form a network of liability. Each segment of the transport is governed by the convention applicable to that type of transportation.

Under the International Chamber of Commerce’s **Rules for Multimodal Transport Documents**, “the carrier must prove during which stage of the multimodal transport the damage occurred.” It also places a presumption in favor of the shipper in the event that the carrier does not meet its burden. “If the stage cannot be established, the system of liability most favorable to the claimant of the relevant modes of transport is deemed to apply.”¹⁷

Containerization poses a number of concerns as it relates to the application of COGSA. First, multimodal transport raises questions about the continued relevancy and importance of the traditional ocean bill of lading; newer multimodal transport documents have increasingly become popular. Second, can a container filled with packages of goods be itself considered a single package for purposes of calculating per package liability?

COGSA provides guidance in defining the word *package*. It states that: “where a container, pallet, or similar article of transport is used to consolidate goods, the number of packages or units enumerated in the bill of lading as packed in such article of transport shall be deemed the number of packages or units.” Courts, in order to protect shippers, have generally held that a container cannot be considered a package. This is especially true when the bill of lading lists a more specific number of units or packages. The more specific description prevails over any general statement referring to the number of “containers.”

The court in *Marcraft Clothes, Inc. v. M/V Kurobe Maru*¹⁸ held that multimodal containers are generally not to be considered as packages for the calculation of COGSA liability of the common carrier. The enumeration on the bill of lading that the container was filled with 4,400 men’s suits made each suit a “package” for purposes of COGSA liability. The issue remains, however, whether the common carrier can expressly designate the container as the package for purposes of COGSA’s per package limitation. Generally, courts have rejected the notion that a container can be designated as a package to limit the carrier’s liability to \$500 for the entire shipment.

In *All Pacific Trading v. Vessel M/V Hanjin Yosu*, the carrier inserted the following clause into the bill of lading: “Where the cargo has been packed into containers it is expressly agreed that the number of such containers shown on the face hereof shall be considered the number of packages for the purpose of the application of the limitation of liability provided for herein.” The carrier further argued that the container was the proper package because the rate agreement was determined based upon the number of containers and not by the number of packages within the containers. The court rejected the carrier’s arguments that the containers were indeed the “packages.” It focused upon the fact that elsewhere on the bill of lading there was a listing of the number of packages in each container.¹⁹

The law on this topic remains unsettled as indicated by the court in *St. Paul Fire and Marine Ins. v. Sea-Land Service*:

*The court notes with some trepidation that it is its view that the determination that the \$500 per package or per customary freight unit limitation should not apply to a container said to contain packages should be re-examined. Cases seeking to apply the limitation to containers pursuant to bills of lading are all too common particularly because carriers have drafted bills of lading with all sorts of terms relating to its applicability to container shipments. Furthermore, because of reasons of reductions of cost and prevention of theft or damage, containers have become a customary freight unit, if not the customary freight unit recognized by COGSA.*²⁰

In order to avoid the classification of a container as a COGSA package, the shipper should request a detailed description in the bill of lading expressly stating the number of packages within each container.

Material Deviation

The next three sections will explore areas of carrier fault that result in the removal of a carrier’s liability limitation under the per package rule. The three areas where the common carrier is held to be fully liable for all damages are material deviation, failure to give fair opportunity to declare a higher value, and **misdelivery**. The first of these three areas of full carrier liability will be reviewed in this section. Material deviation claims can generally be divided into two groups—those involving the above-deck carriage of goods and a change in the expected route of the ship.

Above-deck carriage has historically been considered a material deviation, but this claim has severely diminished in modern times. The advent of containerization and more powerful ships has made above-deck carriage commonplace, since containers help protect the cargo from the adverse conditions of sea travel. Furthermore, modern ships allow for larger cargo capacity by the stacking of containers below and above the deck. For this reason, ocean carriage has become more efficient and reasonable. COGSA permits the parties to agree to above-deck shipment. It states that: “**deck cargo** means cargo which by the contract of carriage is stated as being carried on deck.” Most bills of lading now reflect the practice of above-deck carriage by the incorporation of a clause paramount.

The second ground for a claim of material deviation is an unreasonable route change. If the common carrier fails to follow a customary or reasonable shipping route, then it will be liable for damages resulting from late delivery.

A defense to a material deviation in the route would be a change resulting from an emergency such as mechanical failure or governmental intervention. For example, it would be reasonable for the common carrier to follow instructions to dock at a port for required government inspection or to change route in order to avoid hostilities. The *St. Johns Shipping Corp.* case that follows reviews the material deviation of above-deck stowage.

St. Johns Shipping Corp. v. S. A. Companhia Geral Commercial do Rio de Janeiro

263 U.S. 119 (1923)

Where rosin shipped under a clean bill of lading was stowed on deck, and was jettisoned during the voyage to relieve the ship in a storm, held, that the ship was liable as for a deviation, could not escape by reason of relieving clauses in the bill, and must pay damages measured by the value of the goods at destination. There are three leading classes of cases: (1) where shipment under deck is customary and there is no controlling contract; (2) where shipment on or under deck, at ship's option, is customary and there is no controlling contract; (3) where custom is controlled by contract.

Generally, courts construe the bill of lading, which thus constituted the entire contract between the parties, to give a promise to carry under deck. In the absence of a proved contract modifying the custom, the custom speaks when the bill of lading is silent. However, deck shipment can be controlled by a separate freight contract. There is nothing inconsistent between a bill of lading with no loading endorsement on it, and a written contract allowing shipment on deck. In such a case, there is no duty on the carrier to notify the shipper as to stowage; if the shipper required notice as to how the option was to be exercised, it should have so provided in the contract of affreightment. It was error to hold that the bill of lading and all its terms were wiped out by the absence of a notation on the bill of lading that the shipment was on deck. The consent to deck stowage was sufficiently evidenced in the bill of lading as issued when that document is read in conjunction with the freight contract that preceded it.

Justice McReynolds. The rosin was loaded on board June 11 and clean receipts—without endorsement concerning stowage—were given. Before reaching Rio de Janeiro the vessel encountered a storm and for sufficient

cause the master jettisoned the rosin in order to relieve her. The loss resulted directly from the on-deck stowage. We are not dealing with a case arising under a general port custom permitting above-deck stowage notwithstanding a clean bill, with notice of which all shippers are charged.

When there is no such custom and no express contract in a form available as evidence, a clean bill of lading imports under deck stowage. Upon this implication respondent had the right to rely. To say that the shipper assented to stowage on deck is not correct. It gave the vessel an option, and the clean bill of lading amounted to a positive representation by her that this had been exercised and that the goods would go under deck. By stowing the goods on deck the vessel broke her contract, exposed them to greater risk than had been agreed and thereby directly caused the loss. She accordingly became liable as for a deviation, cannot escape by reason of the relieving clauses inserted in the bill of lading for her benefit, and must account for the value at destination. The decree below is AFFIRMED.

Case Highlights

- Consent to deck stowage can be determined by reviewing the bill of lading in conjunction with other evidence of the freight contract.
- When the bill of lading does not expressly allow for on-deck stowage and there is no port custom permitting on-deck stowage, then above-deck stowage would be considered a material deviation.
- A material deviation precludes the common carrier from utilizing the limitation of liability (per package) protection under COGSA.

The court in *DuPont de Nemours International v. Mormacvega*²¹ recognized an implied exception to the COGSA principle that carriage on the deck of the ship is a material deviation. It held that it is not an unreasonable deviation from the carriage contract to carry the goods above deck if the ship is one designed for above-deck containerized carriage. This can be seen as judicial recognition of the technological developments since the writing of the Hague Rules.

The common carrier generally prevents a material deviation claim for above-deck carriage by inserting a clause paramount in the bill of lading. In essence, the shipper agrees to allow the common carrier to decide whether the

goods are to be carried below or above deck. The clause asserts that the Hague Rules (COGSA) or other pertinent convention will apply to goods stowed above deck. The clause below is an example of a clause paramount. The numbers in parentheses refer to the statements immediately before them and are explained in the paragraph that follows:

*The bill of lading shall have effect subject to all the provisions of the Carriage of Goods by Sea Act of the United States, as approved on April 16, 1936. The defenses and limitations of said Act shall apply to goods whether carried on or under the deck (1), to carriage of goods between U.S. ports, or between non-U.S. ports (4), before the goods are loaded on and after they are discharged from the vessel, and throughout the entire time the goods are in the actual custody of Carrier (2), whether acting as carrier, bailee, or stevedore (3). Carrier shall be entitled to the full benefit of all rights and immunity under and all limitations and exemptions from liability contained in any law of the United States or any other place whose law shall be compulsorily applicable. If any term of this bill of lading is repugnant to the Carriage of Goods by Sea Act or any other law compulsorily applicable, such term only shall be void. This bill of lading shall be construed and the rights of the parties determined according to the laws of the United States (5).*²²

The above clause does more than simply extend COGSA to above-deck carriage (1). It also extends COGSA's coverage beyond tackle-to-tackle to the entire period that the goods are in the possession of the carrier (2). Some courts have recognized this extension of COGSA even when the bill of lading fails to incorporate such a clause.²³ Second, it extends COGSA protection to all third parties involved with the transport of the goods by sea including stevedores (3) (Himalaya Clause). Third, it preempts the application of the Harter Act extending coverage to shipments between U.S. ports (4). Finally, it selects U.S. law as the law to be used to interpret the carriers' obligations and liabilities under the bill of lading (5) (choice of law).

Fair Opportunity

There are a limited number of exceptions to the per package limitation afforded to carriers. One exception is when the shipper is not given a fair opportunity to declare a higher per package value for the goods. Courts will carefully examine the bill of lading itself in deciding whether the common carrier has fulfilled its fair opportunity responsibilities. The court in *Komatsu, Ltd. v. States S.S. Co.*²⁴ held that common carriers' fair opportunity obligations are satisfied when they incorporate the language of Section 1304(5) on the face of the bill of lading. The *Travelers Indemnity Company v. Waterman Steamship Corp.* case further explores the nuances of the carrier's duty to provide an opportunity to declare a higher value.

Travelers Indemnity Company v. Waterman Steamship Corp. (Vessel *Sam Houston*)

26 F.3d 895 (9th Cir. 1994)

Wiggins, Circuit Judge. This action arose when a barge owned and operated by Waterman sank in the inner harbor of Alexandria, Egypt. The barge was carrying machinery and materials for appellant's assured. The shipment consisted of steel, valves, pumps, and other materials to be used in the erection of sewage treatment plants and elevated water tanks. Travelers sustained a loss of \$1,174,876 when a portion of the cargo was lost or damaged. Travelers brought suit against Waterman in federal district

court. The district court found that the \$500 per package or per customary freight unit limitation on liability, set forth in the Carriage of Goods by Sea Act (COGSA), controlled. In addition, the district court found that 77 "packages" were damaged or lost. Thus, the district court entered final judgment for \$38,500.

COGSA regulates the liability of international carriers for loss or damage to cargo. Specifically, Section 4(5) of COGSA provides that a carrier is liable for \$500 per

package or per customary freight unit (46 U.S.C. § 1304 (5)). The shipper may increase the carrier's liability, however, by declaring on the bill of lading the nature and value of the goods shipped and paying a higher freight rate. A carrier may take advantage of COGSA's \$500 per package or per customary freight unit limitation on liability "only if the shipper is given a 'fair opportunity' to opt for a higher liability by paying a correspondingly greater charge."

The fair opportunity requirement is meant to give the shipper notice of the legal consequences of failing to opt for a higher carrier liability. Thus, the carrier must "bear an initial burden of producing *prima facie* evidence that demonstrates that it provided notice of a choice of liabilities and rates to the shipper." Normally, the carrier can meet this initial burden by showing that the language of COGSA Section 4(5) is contained in the bill of lading. Travelers offered two pieces of evidence. First, L.A. Water submitted to Waterman prior to shipment the export declaration it prepared for customs. This export declaration reported the value of the total cargo to be \$6,000,000. Second, Waterman's bill of lading did not contain a designated space in which to declare a higher value. Travelers noted that the *Nemeth* court considered "the fact that the bill of lading contains no designated place for an excess value declaration" to be evidence that the shipper did not

have a fair opportunity to opt out of COGSA's liability limitation.

The export declaration does not, in fact, constitute evidence that the shipper "would have opted for a higher liability had it been given a fair opportunity to do so." The party in this case was a sophisticated shipper of goods. And it had shipped its goods with Waterman on several previous occasions. Thus, the shipper was familiar with Waterman's shipping procedures and its bill of lading. Second, a designated place for an excess value declaration is not mandatory. **AFFIRMED.**

Case Highlights

- A common carrier can take advantage of the \$500 per package limitation only if it gives the shipper a "fair opportunity" to declare a higher value.
- A common carrier will generally meet its burden to provide a fair opportunity to declare a higher value by incorporating the language of § 4(5) of COGSA into the bill of lading.
- Designating a space on the front of the bill of lading to declare a higher value is not required by COGSA.
- A statement of higher value in a document other than the bill of lading, even if provided to the common carrier, is of no consequence.

Misdelivery of Goods

Under COGSA, the carrier is obligated to deliver the goods to the holder, and only the holder, of the bill of lading. A cause of action accrues to the shipper in the event that delivery is made to someone not holding the bill of lading. The common carrier is liable for misdelivery, even after the goods are discharged from its ship, because the carrier remains a **bailee** of the goods until they are delivered to the holder of the bill of lading. The *law of bailment* places special duties of care on a party (bailee) who is entrusted with the goods of another party.

The special status of the common carrier under the law of bailment is explored in the *Allied Chemical International Corp. v. Companhia de Navegacao Lloyd Brasileiro* case. In addition, the case illustrates that even though the bill of lading is the universally accepted document of title, national maritime customs and shipping practices need to be understood in order to protect against misdelivery. Misdelivery can occur when a country's import documentation allows for such a release or when the receiving party and the common carrier make alternative arrangements.

Allied Chemical International v. Companhia de Navegacao Lloyd Brasileiro

775 F.2d 476 (2d Cir. 1985)

Meskill, Circuit Judge. Companhia de Navegacao Lloyd Brasileiro (Lloyd), an ocean carrier, appeals from a judgment of the United States District Court for the Southern

District of New York finding Lloyd liable to Allied Chemical International Corporation (Allied), a shipper, for the misdelivery of goods to the consignee, Banylsa

Tecelagem do Brasil S.A. (Banylsa). The carrier caused the goods to be delivered without requiring Banylsa to produce the original order bill of lading.

Allied, an exporter of chemical products, received from Banylsa an order for a quantity of caprolactam, a crystalline cyclic amide used in the manufacture of nylon. The sale was to be in two lots of 6,000 bags on terms of sight drafts against documents through Banco Bamerindus do Brasil S.A. of Sao Paulo, Brazil (Brazilian bank). Lloyd's vessel arrived at the Port of Salvador and in accordance with local custom and trade usage, the carrier unloaded the caprolactam at a warehouse under the control of the Administration of the Port of Salvador, an agency of the Brazilian government.

Banylsa requested and received from Lloyd in accordance with Brazilian import regulations a "*carta declaratoria*," a letter declaring that the freight had been paid at the port of origin and that the Merchant Marine Renewal Tax had been paid in Salvador. By virtue of the *carta declaratoria*, Banylsa was able to obtain possession although it had not paid for the goods and it was not in possession of the bill of lading. Soon thereafter, Banylsa filed a voluntary receivership proceeding in the Civil Court of the District of Salvador, Brazil. Allied made a demand on Lloyd for losses incurred as a result of the carrier's failure to request proper documentation before authorizing the release of the caprolactam.

The liability question in this case inextricably involves the critical importance of the documentary transaction in overseas trade. The documentary sale enables the distant seller to protect himself from an insolvent or fraudulent foreign buyer by ensuring that the buyer ordinarily cannot take possession of the goods until he has paid for them. It accomplishes this rather simply. The seller tenders shipping documents, including a negotiable bill of lading, rather than goods to the buyer. By paying for the documents, the buyer gets possession of the original bill of lading.

Possession of the bill of lading entitles the holder to possession of the goods; it represents the goods and conveys title to them. Most likely, the bill will be an order

bill of lading, made to the order of or endorsed to the buyer. The carrier, the issuer of the bill of lading, is responsible for releasing the cargo only to the party who presents the original bill of lading. Delivery to the consignee named in the bill of lading does not suffice to discharge the carrier where the consignee does not hold the bill of lading. If the carrier delivers the goods to one other than the authorized holder of the bill of lading, the carrier is liable for misdelivery.

Lloyd contends that clauses 1 and 12 of the bill of lading absolve it from liability. Clause 1 provides that "the Carrier shall not be liable in any capacity whatsoever for any delay, nondelivery or misdelivery, or loss of or damage to the goods occurring while the goods are not in the actual custody of the Carrier." Clause 12 provides that "the responsibility of the Carrier, in any capacity, shall altogether cease and the goods shall be considered to be delivered and at their own risk and expense in every respect when taken into the custody of customs or other authorities." However, when Lloyd discharged the cargo, it assumed the status of a bailee. A bailee is absolutely liable for misdelivering cargo. Therefore, under COGSA, the Harter Act (which still governs the periods prior to loading and after the goods are discharged until proper delivery is made), and the law of bailment, Lloyd is liable for misdelivery. The judgment of the district court is AFFIRMED.

Case Highlights

- The issuer of the bill of lading is responsible for releasing the cargo only to the party who presents the original bill of lading.
- A common carrier is considered as a *bailee* of the goods put in its charge. Therefore, it may be liable in the law of bailment even after it discharges its obligations under COGSA.
- Despite the protections provided for under COGSA and other carriage conventions, it is important to know the local customs and practices of the country of importation.

Alternative arrangements are sometimes made for delivery to someone not holding a bill of lading. One common practice is where the common carrier agrees to release the goods to a consignee, not in possession of the bill of lading, upon the presentment of a bank guarantee. The bank guarantee absolves the carrier from any liability for misdelivery. It is important to note that the carrier remains liable for misdelivery under COGSA, but is able to seek indemnification through the guarantee.

In *C-Art, Ltd. v. Hong Kong Islands Line America, S.A.*,²⁵ the parties' prior course of dealing allowed the importer to present a bank guarantee, rather than wait to receive the bill of lading. However, instead of presenting its normal bank guarantee, the buyer presented a corporate guarantee and received a release

of the goods. The court held the carrier liable for misdelivery by reasoning that “the carrier, the issuer of the bill of lading, is responsible for releasing the cargo only to the party who presents the original bill of lading.”²⁶ It would seem that even if the importer had presented a bank guarantee or indemnity, the carrier still remains liable to the shipper for misdelivery unless the shipper–seller expressly agreed to such a delivery arrangement.

COGSA Exemptions

If the carrier fulfills its obligations as outlined previously, then its liability is limited to not more than \$500 per package. In addition, it obtains the protection of **17 COGSA exemptions** (see Figure 13.2. *Comparative Law*: “17 COGSA Exemptions”). There are 16 enumerated exemptions and one “catch-all” known as the **Q-clause exception**. The 16 enumerated exemptions include losses due to errors in navigation and management of the ship, fire, perils of the sea, acts of God, war, acts of public enemies, government seizure, quarantine restrictions, act or omission of the shipper, strikes, wastage due to inherent vice, insufficiency of packing, and latent defects. Perils of the sea would include violent or catastrophic storms, but not normal storms at sea. Latent defects are those defects not discoverable by due diligence.

The courts have narrowly interpreted most of the exemptions in order to allow shippers to collect on their claims. For example, the latent defect exception has not provided carriers much protection even when they perform due diligent inspections and testing. The “catch-all” exception or Q-clause exception grants the carrier a general exemption for any damages that arise from a cause that was not the “actual fault of the carrier or those of the agents or servants of the carrier.” However, COGSA states that the burden of proof is on the carrier to prove that its fault or negligence had not contributed to the loss or damage. Courts have rarely granted an exemption from liability under the Q-clause. If there is any possibility that the loss or damage occurred while the goods were in the possession of the carrier, no matter how remote, then the court will likely rule against the carrier’s claim of a Q-clause exemption.

Damage to goods attributable to one of these 17 causes, nonetheless, relieves the carrier of *all* liability. In contrast, the Hamburg Rules eliminate these exceptions and provide a presumption of carrier liability for loss except when occasioned by a fire. In addition, COGSA requires the consignee to make a notice of loss “before or after the time of the removal of the cargo, if apparent.” It further provides a limitation period of one year for any claims of loss. The Hamburg Rules allow a claim of loss within one working day after delivery to the consignee. Also, the limitation period is extended to two years. COGSA provides for liability when goods are lost or damaged but makes no mention of liability for a delay in delivery. The Hamburg Rules designate “delay” as an equal ground for recovery.

It also serves to highlight the enumerated exemption of latent defect. The *Lamb Head Shipping v. Jennings* case reviews the perils of the sea exemption and how it interrelates with the carrier’s duty of due diligence.

Neither the carrier nor the ship shall be responsible for loss or damage arising or resulting from:	
a	act, neglect, or default of master or employees in the navigation or in the management of the ship;
b	fire;
c	perils of the sea;
d	act of God (natural disasters);
e	act of war;
f	act of public enemies;
g	arrest or restraint or seizure under legal process;
h	quarantine restrictions;
i	act or omission of the shipper or owner of the goods;
j	strikes, lockouts, or stoppage of labor;
k	riots and civil commotions;
l	saving or attempting to save life or property at sea;
m	wastage in bulk or weight or any other loss arising from inherent vice of the goods;
n	insufficiency of packing;
o	insufficiency of marks;
p	latent defects not discoverable by due diligence;
q	any other cause arising without actual fault or privity of the carrier, but the burden of proof shall be on the person claiming the benefit of this exception.

Figure 13.2 *Comparative Law*: 17 COGSA Exemptions.

Lamb Head Shipping v. Jennings

1 Lloyd's Law Report 624 (C.A. 1994)

The *Marel* sailed from Greece to Ghent with a load of Greek corn. While in route it encountered adverse weather conditions with the wind reaching NE force 7 with a swell of about two or three metres. According to the evidence, witnesses felt a “bump” sufficient to cause the crew to be thrown off balance. Less than one hour later the ship sank. The plaintiffs claimed under their marine hull insurance contending that the vessel was lost due to *perils of the sea*, which was covered under the policy. The sole issue was whether the loss was caused by perils of the sea.

Justice Dillon. The burden of proving on the balance of probabilities that a vessel was lost by perils of the sea was on the owners. It is not sufficient for the owners merely to prove the incursion of seawater into the insured vessel. In fact, *Marel* was not overwhelmed by exceptionally bad weather. It is very nearly impossible that the only form of unidentified object that was suggested as a possibility, a derelict container, caused the casualty. The crucial question is how the flooding of the engine room came about. The plaintiffs assert that it came about by perils of the sea. “Perils of the sea” does not include the ordinary action of wind and waves.

The primary submission for the plaintiff was that *Marel* had hit a floating container that had fallen from some other ship. However, there was no evidence that there had been any report of any container having been lost in the vicinity. The lower court accordingly found that it was wholly improbable that entry of seawater was due to a collision. Though the general condition of the vessel was good for her age, there had been various botched repairs and the owners were not enthusiastic about spending money unnecessarily. We therefore AFFIRM the lower court’s dismissal.

Case Highlights

- The ship owner has the burden to prove a loss due to a “peril of the sea” in making a claim under its marine insurance.
- Peril of the sea does not include the ordinary action of wind and waves.
- Failure to properly repair a ship opens the ship owner to a charge of a lack of due diligence in maintaining the seaworthiness of the vessel.

Freight Forwarders, Consolidators, and Multimodal Transport Operators

The final two parts of this chapter will focus on the role and duties of other essential third parties in the transport of goods. These include the **freight forwarder**, **multimodal transport operator (MTO)**, and **marine insurance company**. The freight forwarder serves three vital functions for importers and exporters: (1) arrange for the shipment of goods with carriers (freight forwarder reserves space on the carrier well before actual shipment date by entering into a **booking contract**), (2) act as a freight consolidator, and (3) process required documentation.

In arranging for the shipment, the forwarder negotiates a freight rate with the carrier as an agent for the shipper. The negative repercussion of the role of the freight forwarder as agent is that it may bind the shipper to modifications made by the carrier to the standard carriage contract. The *Constructores Tecnicos v. Sea-Land Service, Inc.* case, for example, examines the ability of freight forwarders to bind the shipper to a material deviation. It addresses the question of whether the forwarder acts as an agent for the shipper for purposes of imputing the forwarder’s knowledge to the shipper.

Constructores Tecnicos v. Sea-Land Service, Inc.

945 F.2d 841 (5th Cir. 1991)

King, Circuit Judge. The Honduran government awarded Constructores Tecnicos (Contec), a Honduran company, a contract for the construction of 20 testing wells and 13 water wells in Honduras. In order to perform the work,

Contec purchased a Ford LT 9000 Tandem Chassis diesel truck and various drilling accessories, including a portable drilling rig unit from JWS Equipment, Inc., of Moore, Oklahoma. Contec partner Julio Pineda contacted Charles

Pagan of Golden Eagle International Forwarding Co. (Golden Eagle), a freight forwarder, and requested that Golden Eagle arrange for transportation of the truck from Oklahoma to Puerto Cortes, Honduras.

Pagan made the transportation arrangements through Sea-Land Service, Inc. (Sea-Land). He filled out a Sea-Land bill of lading, listing the cargo to be shipped but leaving the space for the freight rate blank. The bill of lading did not indicate whether the cargo was to be stowed on deck or below deck. Pagan then delivered the draft bill of lading to Sea-Land's office. The truck and equipment were loaded on the M/V *Vermillion Bay*, a vessel chartered by Sea-Land. The truck and some of the equipment were secured to a flatrack, a form of open container, by chain lashings and stowed on deck.

The M/V *Vermillion Bay* encountered severe weather in the Gulf of Mexico on the fringes of Hurricane Gilbert. During the storm, nearby containers broke free of their lashings causing severe damage to the truck. The ship changed course and docked at Port Everglades, Florida, where the truck was unloaded and deemed a constructive total loss. Contec brought suit against Golden Eagle, Sea-Land, and International Cargo and Surety Insurance Co. (International Cargo).

COGSA limits an ocean carrier's liability for lost or damaged cargo to \$500 per package. A carrier loses this protection, however, if a deviation from the specifications contained in its contract of carriage with the shipper amounts to more than a reasonable deviation. The district court held that a clean bill of lading entitles the shipper to presume below-deck stowage. The lower court, citing a line of authority dating back to the late 19th century, described the legal effect of a clean bill of lading: "A clean bill of lading imports that the goods are to be safely and properly stowed under deck. Absent an express agreement to the contrary or a port custom permitting on-deck stowage, a shipper may presume that a clean bill of lading will result in carriage of the cargo below deck."

The appellants argue that Contec had not dealt directly with the carrier, but rather through an intermediary freight forwarder who had the power to bind the shipper

to on-deck shipment. We disagree with appellants' suggestion that there is a hard and fast rule deeming freight forwarders to be agents of shippers. In regard to the shipper's selection of the forwarder, obviously this is an indication that the forwarder's actions can be attributed to the shipper. Control of the manner in which the forwarder performs his duties, however, rather than selection, has been the more important factor in deciding the agency question. It is undisputed that the shipper did not control the forwarder's actions in booking cargo. The forwarder was free to select the carrier or line on which to ship the goods and the shipper had little knowledge of the manner in which the forwarder performed its duties, much less controlled the forwarder's performance.

Appellants correctly argue from these facts that Golden Eagle "entered into the contract of carriage on behalf of the shipper," but the conclusion it believes follows—that Golden Eagle's knowledge concerning Sea-Land's practices may be imputed to Contec as a result of an agency relationship—is incorrect without the missing link of control by the shipper over the forwarder's actions. The legal relationship of agency is the threshold question. Only then could the agent's knowledge of the carrier's usual custom of storing oversized containers on deck be deemed sufficient to bind the shipper to a contract in which the shipper consented to on-deck stowage. If the shipper has in no way consented to on-deck stowage, and cannot be deemed to have done so through a freight forwarder acting as its agent, the law's concern is with the shipper's expectations. WE AFFIRM the judgment awarding damages in excess of the COGSA limitation of liability.

Case Highlights

- The freight forwarder acts as agent for the shipper in selecting a common carrier and booking cargo space.
- The freight forwarder's knowledge of a common carrier's practices that would be deemed to be material deviations is not imputed to the shipper.
- An express provision in the bill of lading or port custom may overcome the presumption in favor of below-deck stowage.

It has become a common practice for the forwarder to issue carrier-type documents such as the **forwarder's bill of lading** or receipt. In such cases, the forwarder assumes the liability of a carrier or possibly of a multimodal transport operator. Carrier liability, therefore, may extend not only to the actual carriers, but also to *contractual* carriers. The freight forwarder also serves the important function of consolidating the shipments of a number of shippers to fill all available space being offered by the carrier in order to reduce the freight costs to the individual shippers. Finally, the freight forwarder provides assistance in preparing the necessary documentation needed for

customs clearance. **Customs brokers** are also utilized to deal with customs authorities and to comply with customs regulations.²⁷

MTOs, also known as combined transport operators, arrange for the shipment of goods using different modes of transport such as sea, rail, road, and air. They enter into separate contracts with the individual carriers. The major benefit to the shipper is that the MTO issues a single transport document for the entire transport. The shipper may make a claim for loss against the MTO no matter where the loss occurs during the transport.

Because of the increased use of MTOs and freight forwarders as common carriers, the **through bill of lading** has become a more commonly used document of title. The through bill of lading and the liabilities that emanate from it are explained in the *Mannesman Demag Corp.* case that follows. The case also explains how containerization has transformed the shipping industry and its legal regimes, along with the continued use of the Harter Act to fill in gaps in coverage before and after the goods are loaded or discharged from a ship. *Freight consolidators* are freight forwarders that also provide the service of freight consolidation. This service includes grouping different shipments from various shippers to make up full container loads and saving the customers freight costs.

Mannesman Demag Corp. v. M/V *Concert Express*

225 F.3d 587 (5th Cir. 2000)

Smith, Circuit Judge. This case arises from damage sustained to an oxygen compressor owned by Mannesman while in transport from Bremerhaven, Germany, to Terre Haute, Indiana. Atlantic carried the goods from Bremerhaven to the Port of Baltimore, Maryland, aboard the M/V *Concert Express*. Trism carried the goods from Baltimore to Terre Haute. While in route from Baltimore to Terre Haute, the goods were damaged when Trism's trailer overturned.

There was only one bill of lading for the entire transportation, issued by Atlantic, reflecting an agreement to transport the goods from Bremerhaven, Germany, to the Midwestern United States. The bill is what is called a "through bill of lading." A through bill of lading is one by which an ocean carrier agrees to transport goods to their final destination. Someone else (e.g., railroad, trucker, or air carrier) performs a portion of the contracted carriage. The bill obligates the common carrier to transport the cargo "through" the port to its ultimate destination.

This case presents an issue of first impression regarding the applicability of federal maritime statutes to inland transport under a through bill of lading. Until the advent of the containerization of cargo, the cargo owner typically would enter into a new shipment contract with a new carrier each time the mode of transport changed. An inland carrier—a railroad, trucker, or, in some cases, an inland barge operator—would carry the goods to a seaport under one contract of carriage. There someone, usually a "freight forwarder" acting on behalf of the cargo owner, would arrange to place the goods in the hands of a

steamship line. Different legal regimes arose to govern the parties' rights and liabilities, depending upon the mode of shipment. If the railroad did the damage, then the rules of liability governing railroads would apply. Maritime law would govern the liability of the steamship or ocean leg of the transport.

Along came multimodal or intermodal shipping containers and everything changed. Now, the same steel cargo container can move freely between different modes of transport. Ocean carriers began to offer "door to door" service. Rail carriers, truckers, or other transporters now contract, not with the owner of the goods, but as a subcontractor to the steamship line who has offered a complete transport package. The U.S. Carriage of Goods by Sea Act (COGSA) governs the liability of an ocean carrier on an international through bill of lading. COGSA contains important benefits to the carrier. Inland carriers frequently attempt to take advantage of the benefits afforded by COGSA.

One of COGSA's most important provisions limits a carrier's liability to five hundred dollars (\$500) per package unless the shipper declares a higher value. The higher value would be inserted into the bill of lading and would usually be for the **insured value**. COGSA also contains a one-year limitation for cargo claims. By its terms, COGSA applies "tackle-to-tackle" only; it does not extend to losses that occur prior to loading or subsequent to discharge from a vessel. A Period of Responsibility Clause can be used to extend COGSA's application to the entire time the goods are within the carrier's custody.

Insured Value: The combined value of the goods, inland and ocean freight charges, cost of packaging, freight forwarding and consular fees, and the cost of the insurance.

Atlantic's bill references two statutes, the Carriage of Goods by Sea Act (COGSA) and the Harter Act. Under COGSA, a carrier of goods in international commerce must "properly and carefully load, handle, stow, carry, keep, care for, and discharge the goods carried." The Harter Act imposes a duty of "proper loading, stowage, custody, care, and proper delivery." Although the Harter Act's applicability to international commerce was partially superseded by COGSA, COGSA is applicable only from the time goods are loaded onto the ship until the time the cargo is released from the ship's tackle at port. Therefore, the Harter Act applies to the period between the discharge of the cargo from the vessel and "proper delivery."

Atlantic's bill of lading provides that, to the extent the Harter Act is compulsorily applicable, the Carrier's "responsibility shall be subject to COGSA." It further states that "where COGSA applies, the Carrier shall not be or become liable for any loss or damage in an amount per package or unit in excess of \$500." Therefore, if the Harter Act is compulsorily applicable to Trism's inland transport, the court correctly limited Atlantic's liability to \$500 per package. The Harter Act is at its core a maritime law; the Court is unwilling to rule that simply because private parties enter an intermodal agreement federal maritime legislation is thus extended far beyond its

congressionally intended bounds. The Harter Act is designed solely to regulate the liability of seagoing carriers. That said, the Court finds that the Harter Act does reach to the point at which goods are loaded onto the vehicles of an inland trucker, whether hired by the shipper or the carrier.

In this age of "containerized" cargoes subject to "multimodal" bills of lading, it is often difficult to locate precisely the points of legal delivery. Increasing efficiency and integration in cargo transport continues to blur the lines separating sea carrier responsibilities from those of others. The Court finds it advisable to keep sea carriers to the standards imposed by the Harter Act until goods are in the hands of land carriers and actually leaving the maritime arena. With COGSA covering carriers' legal responsibilities through discharge, Harter fills a potential gap between discharge and inland transit in those situations where goods, though on the dock, are still within the control and responsibility of the sea carrier.

Case Highlights

- A through bill of lading is one by which an ocean carrier or MTO agrees to transport goods to their final destination.
- The Harter Act fills a potential gap between discharge and inland transit in those situations where goods, though on the dock, are still within the control and responsibility of the sea carrier.
- The Harter Act does reach the point at which goods are loaded onto the vehicles of an inland trucker, whether hired by the shipper or the carrier.

Marine Insurance

Under international conventions, such as the Hague Rules and Warsaw Convention, a common carrier's liability is frequently limited. Buyers or sellers of goods protect themselves from carrier liability limitations by making arrangements for cargo insurance against losses due to damage or delay in transit. If the buyer neglects to obtain coverage or obtains too little, damage to the cargo may cause a major financial loss to the exporter. Therefore, even if the terms of sale make the foreign buyer responsible, the exporter should still contemplate obtaining insurance on its own behalf.

Due to the advent of containerization, an insurance policy or policies will need to cover multiple modes of transportation. Shipping goods across national boundaries—from one inland destination to a port of shipment, then to a port of destination and the inland point of destination—involves different types of insurance, including marine, war risk, comprehensive general liability, protection and indemnity, and excess insurance. This is further complicated by the fact that insurance providers will often distribute the risk through **reinsurance**. Marine insurance is a contractual relationship between an underwriter and the insured (shipper), while reinsurance is a contract between different underwriters. As a general rule the insurer may not reinsure on broader terms than are found in the underlying policy.

In order to deal with these different issues of coverage, the transit insurance industry has produced a host of standard forms and clauses. The existence of such standardization, however, should not cloud the fact that the transit insurance policy is often a very specific custom contract. "Even with the extensive use of form policies there are inevitable variations negotiated by the parties. There is simply no substitute for a thorough review of the particular insurance contract in the manner of its negotiation and placement."²⁸

Highly specialized, the marine insurance industry provides a variety of insurance policies, including hull, cargo, and liability policies. These policies protect ship and cargo owners from an assortment of exposures, including damage to goods, damage to the ship, damage to other's property, and liability for injury and death. The most common property coverage is provided by **hull insurance**. The owner or charter party of a vessel generally obtains hull insurance. This protects the owner or charter party from losses due to damage to the vessel or its equipment. War risk coverage is ordinarily excluded from the standard hull and cargo policies. The hull policy is a perils-only type of policy in that one may collect only for losses resulting from expressly listed causes. Therefore, clauses that extend coverage should be carefully considered.

The two most popular extensions are through the **Inchmaree clause** and the **running down clause**. The Inchmaree or additional perils clause extends the list of covered perils usually to include losses due to negligence of the crew and damage arising from a latent defect. This clause is also commonly inserted in cargo insurance policies. The running down clause provides protection from liability for damages to another vessel caused by a collision with the insured ship. The best sources for hull insurance forms and clauses are Lloyd's of London and the American Institute's Hull Clauses.

Liability coverage is provided through protection and indemnity insurance, offered through associations of shipping companies popularly known as P & I clubs. The **Protection and Indemnity (P & I) Policy** provides two broad categories of protection: third-party liability and contractual liability protection. Third-party liability coverage protects against damages caused to others due to marine collision. Contractual liability coverage includes protection against passenger liability, liability for loss and damaged cargo, and the discharge of hazardous materials. When a cargo owner or its insurance company sues the common carrier for cargo damage, the carrier's insurance company will be required to defend or pay the claim.

With the advent of container transport, the **through-transport policy** form of P & I insurance has become popular. A through-transport policy provides indemnification for third-party damage caused during inland transit. Indemnity policies become operative only upon payment by the insured. Another popular policy is the **comprehensive general liability (CGL) coverage**. The **Insurance Services Office (ISO)**, a private trade association, drafts this policy. Two points will be made regarding CGL policies. Their most salient feature is their comprehensiveness. Second, they provide a rather broad duty on the part of the insurer to defend. Thus, the insured is provided with the luxury of having legal services paid for by the insurance company even on claims where insurance coverage is suspect.

Shippers also commonly obtain umbrella or **excess insurance**. Insurance is often multilayered due to the fact that the underlying insurance provider may be unwilling to provide the amount of coverage requested by the insured. The insured may further limit its exposure by obtaining excess coverage for claims that exceed the amount of the underlying policies. The excess insurance policy incorporates one of a number of popular clauses that control when that coverage becomes operational. These clauses relate the excess coverage to the coverage provided by underlying policies. For example, an escape clause precludes any recovery if the type of claim is covered under an existing policy even if that claim exceeds the amount of coverage provided by the underlying policy. An **excess clause** covers all claims outside the coverage of the underlying policy. The **pro rata clause** proportions the amount paid under the policy based upon the limits provided by all relevant policies.

Marine Cargo Insurance

The most relevant policy for exporter and importers of goods is the **cargo policy**. The restrictions on coverage in cargo insurance revolve around three factors: (1) the causes of loss that it protects against, (2) amount of coverage,

Cargo Insurance Certificate: A document indicating the type and amount of insurance coverage in force on a particular shipment. It includes the name of the insurance company and conditions of coverage. The original copy of the Cargo Insurance Certificate is required in the filing of a claim. Copies of documents necessary to support an insurance claim include the insurance policy or certificate, bill of lading, invoice, packing list, and a survey report (usually prepared by a claims agent).

and (3) duration of the coverage. The first factor determines whether to obtain perils or an all risks policy. The second factor affects the decision to insure against only a total loss, known as free of particular average, or to insure against partial losses or *with* average. The third factor involves the incorporation of clauses in the marine insurance that would extend the duration of coverage to periods when the goods are on the shore or in a warehouse. These **extension clauses** include warehouse-to-warehouse, shore, and marine extension clauses.

There are two general types of marine insurance policies: (1) **perils only policy** and (2) **all risks policy**. The most common form of cargo insurance is the perils only policy that pays only for losses due to expressly enumerated perils or causes (see Figure 13.3 *Focus on Transactions*: “Standard Perils Only Policy (ULA’s Cargo B Clause)”).

The burden is on the cargo owner to prove that the loss was due to one of the listed perils.²⁹ Thus, under the perils only policy a loss caused by an unforeseen event or occurrence would be borne by the owner of the goods. In contrast, broader coverage is available through the all risks policy. The all risks policy covers any losses except for those expressly excepted in the policy. The burden to prove that the loss was due to an excluded clause is placed upon the insurance company. Standard cargo policies, both of the perils only and all risks varieties, will not cover risks associated with war, revolution, riot, or strikes. These areas of loss are exempted by the **F.C. & S. clause** (free of capture and seizure) and the **S.R. & C.C. clause** (strikes and riots). The F.C. & S. clause has been interpreted to exclude any losses due to war or civil strife, including rebellion and revolution. Coverage may be requested through an endorsement on the underlying policy or through a separate **war risk policy**. This decision is likely to be based upon the particular places of shipment and destination, along with the expected route of transport and the types of goods being transported.

Marine insurance policies also generally specify whether they cover less than total losses, known as **with average**, or whether they cover only total losses, **free of particular average (FPA)**. The marine term for loss is the word *average*. The more comprehensive policy is one *with average*. This policy protects for partial as well as total losses. However, most with average policies restrict the coverage for partial losses to those losses that exceed 3 percent of the value of the goods. The free of particular average clause states that the insurance company does not have to pay the insured (assured) if he suffers less than a total loss. This type of limited coverage is not favored. More recently, the Institute of London Underwriters opted to eliminate free of particular average from its standard clauses. Instead, it provides an alternative clause that allows the insurance company to narrow the list of specified risks that would be covered under the standard perils only policy.

This insurance covers:		e	discharge of cargo at a port of distress
		f	earthquake, volcanic eruption, or lightning
1	Loss or damage to the goods insured reasonably attributable to:	2	Loss or damage caused by:
a	fire or explosion	g	general average sacrifice
b	vessel or craft being stranded, grounded, sunk, or capsized	h	entry of sea, lake, or river water into vessel or place of storage
c	overturning or derailment of land conveyance	i	jettison or washing overboard
d	collision or contact of vessel or craft with any external object other than water	3	Total loss of any package lost overboard or dropped while being loaded on to or unloaded from vessel or craft.

Figure 13.3 *Focus on Transactions*: Standard Perils Only Policy (ULA’s Cargo B Clause) (Risks Covered).

Marine cargo insurance traditionally covers only the period that the goods are on the ship. Due primarily to the importance of the bill of lading and the use of multimodal containers, the cargo policy is often made to cover risk of loss for periods of time before the loading and after the unloading of the goods. Incorporating a warehouse-to-warehouse or marine extension clause in the insurance policy that protects the shipper from the start in the exporter's country until received in the importer's country generally does this (see Figure 13.1: "Warehouse-to-Warehouse Clause"). The marine extension or warehouse-to-warehouse clause extends the standard marine coverage to the period before the loading of the goods and the period between offloading and delivery to the consignee. It is important to make sure that the clause does not limit the extended coverage through a time limit provision. The best way to ensure this is to provide that the policy remains in operation until the goods are delivered to the consignee.

The *Shaver Transportation Co.* case is an excellent review of some of the standard clauses found in most marine insurance policies. Marine insurance policies are directed at one of two intended beneficiaries—the shipper and the common carrier. The clauses reviewed in *Shaver Transportation Co.* apply equally to both perils only and all risk insurance policies. The clauses in the marine insurance policy that are referred to in the case have been excerpted and placed in Figure 13.4 *Focus on Transactions*: "Standard Marine Insurance Clauses." It is important to refer to these clauses when reading the case.

Shaver Transportation Co. v. Travelers Indemnity Co.

481 F. Supp. 892 (D.C. Oregon 1979)

Skopil, District Judge. Shaver Transportation Company (Shaver), a barge company, contracted with Weyerhaeuser Company (Weyerhaeuser) to transport caustic soda from Weyerhaeuser plants to a buyer of the soda, GATX. Following the terms of the agreement, Shaver arranged for marine cargo insurance with Travelers. Shaver decided on "Free from Particular Average" and "standard perils" provisions supplemented with "specially to cover" clauses. Upon delivery to GATX, it was determined that the soda had been contaminated with tallow.

The parties agree that contamination occurred as Shaver was loading the caustic soda aboard the barge. The barge had previously carried a load of tallow, and Shaver had not thoroughly cleaned the barge input lines. Shortly thereafter Travelers notified Shaver that the contamination did not represent a recoverable loss under the defendant's marine open cargo policy. There is only one major issue in the case: Are the losses incurred by the plaintiffs the consequences of an insured event under the marine cargo insurance policy? Plaintiffs have meticulously examined the policy and argue for recovery under several theories.

I. Recovery under Perils of the Sea Clause and Free from Particular Average Clause

The Perils clause, almost identical to ancient perils provisions dating back several hundred years, defines the risks protected by the policy. In addition to a long list

of "perils of the sea," the clause includes "all other perils, losses, and misfortunes, that have or shall, come to the hurt, detriment, or damage to the said goods and merchandise." Plaintiff argues that the "forced" disposition of the caustic soda was like jettison (an enumerated peril) and is covered by the concluding language of the clause.

The contamination of the cargo occurred at the time of loading. Therefore, the plaintiffs cannot recover under the Perils clause of the policy. The term "jettison" also appears in the Free from Particular Average clause. If jettison did occur, this clause affords coverage regardless of the amount of cargo damage. However, I find that a jettison did not occur in this instance.

II. Recovery under Warehouse-to-Warehouse Clause; Marine Extension Clause; Shore Coverage Clause

These clauses do not define the nature of the risks covered by the policy but merely define where physically the coverage extends. To recover under either the Warehouse-to-Warehouse or the Marine Extension clause the plaintiffs must show that an insured peril existed and the damage was proximately caused by that peril. The shore coverage clause provides coverage for enumerated risks occurring on shore. Plaintiffs argue that contamination while loading is a shore accident. However, since the contamination occurred within the barge's intake

lines, the incident arose “on board.” Therefore shore coverage does not apply. Even if it were to apply, contamination of cargo is not within the enumerated risks covered by the shore coverage clause.

III. Recovery of Extraordinary Expenses under Landing and Warehousing Clause; Extra Expenses Clause; Sue and Labor Clause

Under these provisions the insured is entitled to recover expenses associated with losses incurred as a result of an insured peril. I find that the losses suffered by plaintiffs were not caused by a peril covered by the policy. Recovery under these provisions is therefore precluded.

IV. Recovery under Inchmaree Clause

The purpose of the Inchmaree clause is to expand the coverage of the policy beyond the perils provision. It allows a vessel owner to become exempt from liability for fault or error in navigation or management of the ship. In contrast, the shipowner must retain liability for negligence in the care and custody of the cargo. The Ninth Circuit, noting that no precise definitions exist, advocates a case-by-case determination using the following test: “If the act in question has the primary purpose of affecting the ship, it is ‘in navigation or in management’; but if the primary purpose is to affect the cargo, it is not ‘in navigation or in management.’” Using this test, I find that the contamination of the cargo in this case was caused by fault in the care, custody, and control of the cargo.

V. Recovery under Negligence Clause

The Negligence clause provides coverage against losses due to enumerated perils caused by the unseaworthiness of the vessel. To recover under this clause plaintiffs must show that the barge was unseaworthy. This unseaworthiness must then cause a loss through one of the enumerated perils: “sinking, stranding, fire, explosion, contact with seawater, or by any other cause of the nature of any of the risks assumed in the policy.” “Seaworthiness” depends on such factors as the type of vessel, character of the voyage, reasonable weather, navigational conditions, and type of cargo.

A vessel is unseaworthy if she is not reasonably fit to carry cargo she has undertaken to transport. I find Shaver’s barge unseaworthy as a result of improper loading of cargo. Plaintiffs must demonstrate that the unseaworthiness of the barge caused a loss to cargo by one or more of the enumerated perils. Since contamination is not an enumerated peril, no recovery is possible under the Negligence clause of this policy.

Even assuming that a peril existed, defendant claims that contribution cannot be requested when the vessel owner was at fault in creating the situation. Vessel owners have long placed in bills of lading a provision incorporating the protections of the Harter Act and Carriage of Goods by Sea Act. This provision, known as the Jason clause, entitles shipowners to contribution notwithstanding negligence in creating the general average situation. However, the shipowner must comply with 46 U.S.C. § 1303(1) (a) requiring due diligence to make the vessel seaworthy. The burden of proving “due diligence” in making the vessel seaworthy falls on the vessel owner. I find that Shaver did not meet this burden. Shaver failed to properly clean or inspect the barge’s input lines. Shaver failed to use due diligence to make the barge seaworthy. Judgment shall be entered for the defendant.

Case Highlights

- Warehouse-to-warehouse and shore clauses do not define the nature of the risks covered by the policy but merely define where physically the coverage extends.
- The Inchmaree clause allows a vessel owner to become exempt from liability for fault or error in navigation or management of the ship. In contrast, the shipowner must retain liability for negligence in the care and custody of the cargo (stowage).
- A vessel is unseaworthy if she is not reasonably fit to carry cargo she has undertaken to transport.
- Since contamination is not an enumerated peril, no recovery is possible under the negligence clause.
- The Jason clause allows shipowners to collect general average damages notwithstanding their negligence in creating the general average situation (see next section on general average).

Cargo insurance can be obtained for a single voyage or a fixed period of time. The most common form in exporting is the open or **general cover** form of insurance policy, which is not limited to a specific shipment but covers numerous shipments for a fixed period of time or until terminated by notice given by the shipper (insured) or the insurance company. The premium is calculated on the basis of the values declared by the shipper on the

PERILS CLAUSE. Touching the adventures and perils which the said Assurers³⁰ are contented to bear, and take upon themselves, they are of the seas and inland waters, man of war, fires, enemies, pirates, rovers, assailing thieves, jettisons,³¹ letters of mart,³² reprisals, taking at sea, arrests, restraints and detentions of all kings, princes of people of what nation, condition or quality whatsoever, barratry of the master and mariners,³³ and all other perils, losses and misfortunes, that have or shall come to the hurt, detriment or damage to the said goods and merchandise, or any part thereof.

FREE OF PARTICULAR AVERAGE CLAUSE. Other shipments covered hereunder are insured: Free of Particular Average unless caused by the vessel and/or interest insured being stranded, sunk, burst, on fire or in collision with another ship or vessel or with ice or with any substance other than water, but liable for jettison and/or washing overboard, irrespective of percentage.

WAREHOUSE-TO-WAREHOUSE CLAUSE. This insurance attaches from the time the goods leave the Warehouse and/or Store at the place named in the policy for the commencement of the transit and continues during the ordinary course of transit, including customary transshipment if any, until the goods are discharged overside from the overseas vessel at the final port. Thereafter the insurance continues whilst the goods are in transit and/or awaiting transit until delivered to final warehouse at the destination named in the policy or until the expiry of 15 days (or 30 days if the destination to which the goods are insured is outside the limits of the port) whichever shall first occur. The time limits referred to above to be reckoned from midnight of the day on which the discharge overside of the goods hereby insured from the overseas vessel is completed. Held covered at a premium to be arranged in the event of transshipment, if any, other than as above and/or in the event of delay in excess of the above time limits arising from circumstances beyond the control of the Assured.

MARINE EXTENSION CLAUSE. This policy is extended to cover all shipments which become at risk hereunder in accordance with the following clauses:

- I This insurance attaches from the time the goods leave the warehouse at the place named in this policy . . . and continues until the goods are delivered to the final warehouse.
- II This insurance specially to cover the goods during deviation, delay, forced discharge, reshipment, and transshipment.
- III This insurance shall in no case be deemed to extend to cover loss, damage, or expense proximately caused by delay or inherent vice or nature of the subject-matter insured.

SHORE COVERAGE CLAUSE. Including while on docks, wharves or elsewhere on shore and/or during land transportation, risks of collision, derailment, fire, lightning, sprinkler leakage,

cyclones, hurricanes, earthquakes, floods, the rising of navigable waters, or any accident to the conveyance and/or collapse and/or subsidence of docks and/or structures, and to pay loss or damage caused thereby, even though the insurance be otherwise F.P.A.

LANDING AND WAREHOUSING CLAUSE. Notwithstanding any average warranty contained herein, these Assurers agree to pay landing, warehousing, forwarding or other expenses and/or particular charges should same be incurred, as well as any partial loss arising from transshipment. Also to pay the insured value of any package, piece, or unit totally lost in loading, transshipment, and/or discharge.

EXTRA-EXPENSES CLAUSE. Where, by reason of a peril insured against under this policy, extra expenses are incurred to destroy, dump, or otherwise dispose of the damaged goods, or where extra expenses are incurred in discharging from the vessel and/or craft and/or conveyance, such expenses will be recoverable in full in addition to the damage to the insured interest.

SUE AND LABOR CLAUSE. In case of any loss or misfortune, it shall be lawful and necessary to and for the Assured, his or their factors, servants and assigns, to sue, labor, and travel for, in, and about the defense, safeguard, and recovery of the said goods and merchandise, or any part thereof without prejudice to this insurance; nor shall the acts of the insured or insurers, in recovering, saving, and preserving the property insured, in case of disaster, be considered a waiver or an acceptance of abandonment; to the charges whereof the said Assurers will contribute according to the rate and quantity of the sum herein insured.

INCHMAREE CLAUSE. This insurance is also specially to cover any loss of or damage to the interest insured hereunder, through the bursting of boilers, breakage of shafts or through any latent defect in the machinery, hull, or appurtenances, or from faults or errors in the navigation and/or management of the vessel by the Master, Mariners, Mates, Engineers, or Pilots; provided, however, that this clause shall not be construed as covering loss arising out of delay, deterioration or loss of market, unless otherwise provided elsewhere herein.

NEGLIGENCE CLAUSE. The Assured are not to be prejudiced by the presence of the negligence clause and/or latent defect clause in the bills of lading and/or charter party and/or contract of affreightment. The seaworthiness of the vessel and/or craft as between the Assured and Assurers is hereby admitted, and the Assurers agree that in the event unseaworthiness or a wrongful act or misconduct of shipowner, charterer, their agents or servants, shall, directly or indirectly, cause loss or damage to the cargo insured by sinking, stranding, fire, explosion, contact with seawater, or by any other cause of the nature of any of the risks assumed in the policy, the Assurers will (subject to the terms of average and other conditions of the policy) pay to an innocent Assured the resulting loss.

Figure 13.4 *Focus on Transactions*: Standard Marine Insurance Clauses.

Source: from *Shaver*.

certificates issued for each shipment. A variant of the open cover policy is the **blanket policy** in which the shipper is not required to declare the individual values of each shipment. Each shipment is covered up to the maximum amount of the policy.

Marine insurance policies have been standardized through the use of common clauses published by one of a number of associations. An example is the **Institute of London Underwriters (ILU)**. Founded in 1884, the ILU is

an association of marine insurance companies that publishes a manual of standard clauses. The sophisticated international exporter or importer should familiarize herself with the standard forms and clauses published by the ILU, the **American Institute of Marine Underwriters (AIMU)**, and Lloyd's of London. An example of such publications is the manual on Cargo Clauses published by the AIMU. Familiarization with the standard forms is important because underwriters will often create their own policies by using clauses found in the standard forms. "Frequently, the standard clauses will be removed from the standard form and used as building blocks in custom policies. In addition the ILU and AIMU have drafted standard terms for particular trades."³⁴

General Average

General average is a venerable doctrine of maritime law that dates back 2,800 years. The doctrine provides that when a portion of a ship's cargo is sacrificed to save the rest from a real and substantial peril, each owner of property saved contributes ratably to make up the loss of the sacrificed property's owners. The United States Supreme Court in *Barnard v. Adams*³⁵ described three events that create a general average situation: (1) a common danger to which ship, cargo, and crew are all exposed and which is imminent; (2) a voluntary sacrifice of a part for the benefit of the whole; and (3) successful avoidance of the peril.

Modern law has eased the imminent requirement by requiring only that a peril be real and substantial. Two classes of general average claims exist: those which arise from sacrifices of part of a ship or cargo made to save the whole venture, and those which arise out of **extraordinary expenses** incurred by the shipowner for the joint benefit of ship and cargo. Thus, general average claims are available to both shipowners and cargo owners. The international convention that governs the calculation of general average losses is the **York-Antwerp Rules**. The *Folger Coffee Company v. Olivebank* case involves a claim for general average by a common carrier against cargo owners.

Folger Coffee Company v. Olivebank

201 F.3d 632 (5th Cir. 2000)

Farris, Circuit Judge. In this admiralty and maritime appeal, Folger Coffee Co. and its insurer, Gulf Insurance Company, seek to reverse the district court's judgment that (1) the vessel M/V *Olivebank* is entitled to use general average on a salvage lien and (2) that Folger Coffee and Gulf Insurance owe their proportional share to the general average fund. The M/V *Olivebank* left the Port of Durban, South Africa, with cargo that included granite blocks, steel wire, and earth-moving equipment.

During the voyage the vessel encountered severe weather and extremely rough seas that caused seawater to come over the deck. The vessel's emergency electrical system, required by the Safety of Life at Sea Convention of 1974, should have provided emergency lighting from batteries, followed by the automatic startup of the emergency generator to provide electrical services for steering. The batteries failed and the emergency generator was ultimately started manually. The parties dispute the exact means by which the seawater reached the alternator room. It is, however, undisputed that a skylight, or raised hatch, nine feet above deck and two levels above the alternators was open at some point during the relevant

period. It is also undisputed that outside deck-level vent covers to the exhaust vents were open and that these vents lead to the alternator room.

The captain of the vessel put out a Mayday. He entered into a salvage agreement with Pentow Marine, Ltd., a salvage tug, pursuant to a Lloyd's Open Form. The salvors arrived in the late afternoon. The main engines were ultimately started prior to the arrival of the salvors, and, after waiting out the storm, the M/V *Olivebank* sailed to a port of refuge on its own power. The salvors exercised their salvage lien by threatening arrest of the cargo and/or the ship.

The owners of the M/V *Olivebank* declared general average, forcing the cargo interests to provide general average bonds and guarantees. Folger Coffee and Gulf Insurance filed actions in district court seeking a declaration that the vessel was not entitled to general average and recovery for damage to cargo. The district court found that the loss of power was caused by a fortuitous combination of events and that the vessel was seaworthy when it left port.

Folger Coffee and Gulf Insurance maintain that the M/V *Olivebank* was not entitled to general average

because the vessel was unseaworthy under the Carriage of Goods at Sea Act, 46 U.S.C. §§ 1300–1315. The parties do not dispute that the bill of lading covering the cargo aboard the *M/V Olivebank* required general average contribution. Under COGSA, once the vessel establishes that a general average act occurred, the cargo owner might avoid liability only by establishing that the vessel was unseaworthy at the start of the voyage and that the unseaworthiness was the proximate cause of the general average event. If the cargo owner proves unseaworthiness, the vessel may still prevail by proving that it exercised due diligence to make the vessel seaworthy prior to the voyage.

The district court held that the evidence did not support the proposed finding that the vessel was unseaworthy due to a defective emergency electrical system. The district court found that the failure of the batteries and emergency system was due to the same intervening event that caused the primary alternators to fail (entry of seawater) and that the collapse of both systems at the same time was fortuitous. The district court held that the *M/V Olivebank* was seaworthy when it left port and that the open skylight and the vent covers were not an issue of seaworthiness but a management decision. The district court did not commit clear error by finding the vessel seaworthy despite the entry of seawater. It found that the water came onto the ship over the stern in a storm with force 11 winds. This finding has support in the record.

Folger Coffee and Gulf Insurance also contend that the conditions of the skylight, or hatch, and vent covers and the fact that these items were not closed made the vessel unseaworthy. The district court found that the most likely

explanation for the entry of water into the alternator room was through the hatch and the exhaust vents and that the vessel was relieved of liability because the decision not to close the skylight or the vent covers was a management decision.

COGSA “excepts the carrier for liability from damage caused by ‘act, neglect, or default of the master, mariner, pilot, or the servants of the carrier in the navigation or in the management of the ship.’” Failure to detect a flaw prior to sailing constitutes a failure to exercise due diligence and not an error of management. There is a fine line between actions that constitute errors in management and inaction that constitutes a lack of due diligence. Folger Coffee and Gulf Insurance have misconstrued the district court’s use of the phrase “management decision.” Neglect by management also relieves liability under COGSA. **AFFIRMED.**

Case Highlights

- Under COGSA, once the vessel establishes that a general average act occurred, the cargo owner might avoid liability only by establishing that the vessel was unseaworthy at the start of the voyage and that the unseaworthiness was the proximate cause of the general average event.
- There is a fine line between actions that constitute errors in management for which the carrier is exempted and inaction that constitutes a lack of due diligence.

Chapter Summary

- 1 One of the most important parts of international sales is the transport of goods. Almost all shipment of goods sent across the world include the use of a cargo ship. Depending on how close to a port a company is located will depend on the types of common carriers used to transport the goods to the buyer. Commonly, multiple modes of transportation are used in the international transport of goods, including, trucks, railroads, and ships.
- 2 Each of the different modes of transport is regulated by international carriage conventions. The purposes of carriage conventions include: (1) establishing the duties and responsibilities of the common carrier, (2) insuring the shipper a certain level of damages in case of loss or damage to its goods, (3) limiting the liability of the common carrier, (4) providing a number of exemptions to the common carrier that would excuse them from any liability for loss due to one of the exemptions, and (5) requiring the common carrier to issue a document that shows ownership in the goods and the party to which the goods are to be delivered. In carriage by sea, the bill of lading is the key title of document.
- 3 There are three major international ocean carrier conventions: Hague Rules, Hague-Visby Rules, and the Hamburg Rules. When a country adopts a carriage convention into law it is often retitled as the Carriage of

Goods by Sea Act or COGSA. For example, the US COGSA is an adoption of the Hague Rules, while the United Kingdom's COGSA is an adoption of the Hague-Visby rules.

- 4 Under COGSA, the common carrier's liability is capped by a per package limitation. The shipper collects the actual value of the goods not to exceed \$500 per package (Hague Rules). In cases of bulk transfers, the "package" would be a customary freight unit (CFU), such as a barrel of oil, ton of coal, or cubic yard of corn. COGSA also provides 17 exemptions including "perils of the sea" and the "Q-clause exception" in which the common carrier is free from liability. The common carrier's protections may be extended to other parties, such as stevedores, through a Himalaya clause.
- 5 Common carriers have a number of duties, including providing a seaworthy ship, proper stowage of goods (secure placement of the goods in or above the deck of the ship), taking the contracted or customary sea route, and delivering the goods to the correct party (party holding the bill of lading). The carrier also has the duty to provide a fair opportunity for a shipper to declare a higher value (above the per package limit) for the goods. Providing a space on the bill of lading where the shipper can enter the actual value of the goods fulfills the fair opportunity obligation.
- 6 Shippers also use other third parties in the shipment process, including freight forwarders, freight consolidators, and customs brokers. In order to simplify the process of securing the different modes of transportation (truck, rail, and ocean carriage), along with the different bills of lading associated with each mode, multimodal transportation has become popular. In multimodal shipment, the shipper hires a single company to arrange all of the different legs of the shipment, and that company issues a single multimodal bill of lading.
- 7 The other major component of the shipping process is the procurement of suitable marine or cargo insurance. So, for example, if the common carrier were exempted due to the COSGA liability exemptions, the shipper would be able to make a claim under its insurance policy. There are many different types of marine insurance policies and clauses. The policy the shipper obtains or clauses the shipper negotiates will determine the types and amounts of losses the shipper is protected against. The most common policy is one "with average," which allows claims for partial loss or harm to the goods. There are two general types of marine insurance policies: (1) perils only policy and (2) all risks policy. The most common form of cargo insurance is the perils policy that pays only for losses due to expressly enumerated perils or causes.
- 8 Another important issue in obtaining marine insurance is the period of time in which the insurance is in effect. The most common form in exporting is the open or general cover form of insurance policy, which is not limited to a specific shipment, but covers numerous shipments for a fixed period of time or until terminated by notice given by the shipper (insured) or the insurance company.
- 9 Under principles of maritime law, a shipper may be liable for damage caused to another shipper's goods under the doctrine of general average. The York-Antwerp Rules provide the means for *pro rata* assessment to all shippers with cargo on board a ship in which other shippers' goods were lost or damaged for the greater good of the ship and the remaining cargo. General average liability also occurs when the shipowner expends extraordinary expenses to insure the safe transport of the goods. In such cases, the shippers are obligated to pay a *pro rata* share of the extraordinary expenses.

Key Terms

17 COGSA Exemptions	Cargo Insurance Certificate	Common Carrier
Air Waybill	Cargo Policy	Containerization
All Risks Policy	Carriage of Goods by Sea Act (COGSA)	Customary Freight Unit (CFU)
American Institute of Marine Underwriters (AIMU)	Charter Party	Customs Brokers
Bailee	Clause Paramount	Deck Cargo
Blanket Policy	Comprehensive General Liability (CGL) Coverage	Due Diligence
Booking Contract		Excess Clause
		Excess Insurance

Exculpatory Clause	Institute of London Underwriters (ILU)	Q-Clause Exception
Extension Clause	Insurance Services Office (ISO)	Reinsurance
Extraordinary Expenses	Insured Value	Rules for Multimodal Transport Documents
F.C. & S. Clause	International Monetary Fund (IMF)	Running Down Clause
Fair Opportunity	Marine Extension Clause	S.R. & C.C. Clause
Federal Arbitration Act (FAA)	Marine Insurance Company	Seaworthiness
<i>Force Majeure</i> Clause	Material Deviation	Shortage
Forwarder's Bill of Lading	Misdelivery	Special Drawing Rights (SDR)
Free of Particular Average (FPA)	Multimodal Transport	Statute of Limitations
Freight Forwarder	Multimodal Transport Convention	Stowage
General Average	Multimodal Transport Operator (MTO)	Through Bill of Lading
General Cover	Ocean Bill of Lading	Through-Transport Policy
Hague Rules	On-Board Bill of Lading	Unimodal Transport Convention
Hague-Visby Rules	Per Package Limitation	War Risk Policy
Hamburg Rules	Perils Only Policy	Warehouse-to-Warehouse Clause
Harter Act of 1893	<i>Pro Rata</i> Clause	Warsaw Convention
Himalaya Clause	Protection and Indemnity (P & I) Policy	With Average
Hull Insurance		York-Antwerp Rules
Inchmaree Clause		

Chapter Problems

- 1 What is the purpose of international carriage conventions? Why are they needed? Why are they important? In what ways do they favor the shipping companies or common carriers? What benefits do the international carriage conventions provide to the shippers?
- 2 What are the functions of freight forwarders and what is the relationship between freight forwarders and the exporters?
- 3 A shipper obtains a marine (cargo) insurance policy for \$25,000 on goods that had a real or market value of \$8,000. If the goods are lost at sea, is the insurance company liable for \$25,000, \$8,000, or nothing?
- 4 An insured takes out a marine insurance policy on \$50,000 worth of goods but fails to disclose his previous claims history. In fact, the insured had filed claims for loss on eight previous policies covering transport of goods. Can the insurance company avoid making payment for loss to the insured goods?
- 5 A shipper obtains a cargo insurance policy on 400 sealed crates of "Grade A" industrial grinding wheels. In fact, the grinding wheels were contained in 400 burlap sacks and were of secondhand stock. Does such a variation in the description of the insured goods jeopardize the shipper's coverage?
- 6 Goods are jettisoned from a ship as a general average act. You file a claim against your marine insurance policy and receive full payment. Does the marine insurance company have a claim for general average against the shipowner and the other cargo owners?
- 7 During a time of hostilities, a shipowner hires a tug to tow the ship to lessen the danger from enemy submarines. Can the shipowner make a general average claim by arguing that the towing costs are extraordinary expenses incurred for the benefit of the ship and its cargo?
- 8 Plaintiff Tseng boarded an international flight from New York to Tel Aviv. Before being allowed to board, she was subjected to an intrusive security search. Tseng sued the airline in state court in New York for the torts of assault and false imprisonment. The Warsaw Convention does not address such an injury. Will Tseng be allowed to continue her action under New York law? *El Al Israel Airlines, Ltd. v. Tseng*, 119 Sup. Ct. 662 (1999).

- 9 The plaintiffs are Dutch importers of commodities that included industrial leather gloves. Four shipments of gloves were made in 1982 and 1983. The insurance contract contained the following clause: "This insurance shall in no case be deemed to extend to cover loss damage or expense proximately caused by *inherent vice* or nature of the subject matter insured." The plaintiff claimed that the dropping of water from a source external to the goods damaged the gloves. The defendant asserted that the goods deteriorated as a result of their natural behavior. In short, the goods were damaged because the leather was not properly dried by the plaintiff. Is this a case of inherent vice? *Noten v. Harding*, 2 *Lloyd's Law Report* 283 (English Court of Appeal 1990).

Internet Exercises

- 1 Review the web site of the International Maritime Bureau: www.iccwbo.org/ccs/menu_imb_bureau.asp. What types of services does this organization provide to international shippers?
- 2 Research the status of the BOLERO Project in the development of electronic documentation relating to the shipment of goods at www.bolero.net.
- 3 Your company has just entered into an export contract with a company in Chile. It is your job to arrange transport from the Port of Miami to Santiago, Chile. Check the shipping schedules to determine the best and fastest transit routes.

Other Internet Sources

Transportation Law Navigator—air and ocean transport: www.cargolaw.com.

English Carriage of Goods by Sea Act of 1971 (Hague-Visby Rules): www.jus.uio.no/lm/england.carriage.of.goods.by.sea.act.1971/doc.html.

Hamburg Rules: www.jus.uio.no/lm/un.sea.carriage.hamburg.rules.1978/doc.html.

ICC International Maritime Bureau: www.iccwbo.org/ccs/menu_imb_bureau.asp

Law of Freight Forwarding: www.unzco.com/basicguide/c10.html; and <http://www.forwarderlaw.com>.

Insurance Services Office: www.iso.com.

American Institute of Marine Underwriters: www.aimu.org.

Institute of London Underwriters: www.iau.co.uk.

Notes

- 1 The formal name of the Hague Rules is the Brussels Convention for the Unification of Certain Rules Relating to Bills of Lading.
- 2 46 U.S.C. App. §§ 190–196 (1988).
- 3 46 U.S.C.A. § 1304.
- 4 *General Elec. Co. v. Inter-Ocean Shipping*, 862 F.Supp. 166, 169 (S.D. Tex. 1994).
- 5 See *Wemhoener Pressen v. Ceres Marine Terminals*, 5 F.3d 734 (4th Cir. 1993).
- 6 46 U.S.C. Appendix § 1304 (5).
- 7 900 F.2d 714 (4th Cir. 1990).
- 8 *Cincinnati Milacron Ltd. v. M/V American Legend*, 784 F.2d 1161 (4th Cir. 1986).
- 9 See *Mori Seiki USA, Inc. v. M/V Alligator Triumph*, 990 F.2d 440 (9th Cir. 1993).
- 10 515 U.S. 528 (1995).
- 11 9 U.S.C.A. §§ 1, 2, 201 *et seq.*, 202.
- 12 881 F.2d at 761, 768 (9th Cir. 1989).
- 13 An excerpt of this case is used in this chapter because it pertains to the enumerated exemption of "latent defect."
- 14 720 F.2d 629 (11th Cir. 1983).
- 15 In the United States, see Article 7 of the Uniform Commercial Code for domestic transactions. For international transactions involving bills of lading, refer to the Federal Bills of Lading Act, 49 USCA §§ 80101-16.

- 16 A *container* is a uniform, reusable metal box in which goods are shipped by vessel, truck, or rail. Standard lengths include 10, 20, 30, and 40 feet (40-foot containers generally hold about 40,000 pounds of cargo). See also Laurence Alexander, "Containerization, the Per Package Limitation, and the Concept of 'Fair Opportunity,'" 11 *The Maritime Lawyer* 123 (1986).
- 17 Frank G.M. Smeele, "The Contract of Carriage" in *International Contracts: Aspects of Jurisdiction, Arbitration and Private International Law* 257 (ed. Marieele Koppenol-Laforce, 1996).
- 18 575 F. Supp. 239 (SDNY 1983).
- 19 See *Universal Leaf Tobacco Co. v. Companhia De Navegacao Maritima Netumar*, 993 F.2d 414 (4th Cir. 1993) (courts will not consider a container as a package if the bill of lading discloses the number of packages within the container).
- 20 745 F. Supp. 186, 189.
- 21 493 F.2d 97 (2d Cir. 1974).
- 22 This clause was taken from *St. Paul Fire & Marine Ins. v. Sea-Land Service*, 745 F.Supp. 186, 188 (SDNY 1990).
- 23 See *Binladen BSB Landscaping v. M/V Nedlloyd Rotterdam*, 759 F.2d 1006 (2d Cir. 1985).
- 24 674 F.2d 806 (9th Cir. 1982).
- 25 940 F.2d 530 (9th Cir. 1991).
- 26 *Ibid.* at 542. See *The Caledonia*, 157 U.S. 124 (1895).
- 27 See Chapter 6, "National Import and Export Regulation."
- 28 Raymond P. Hayden and Sanford E. Balick, "Marine Insurance: Varieties, Combinations, and Coverages," 66 *Tulane Law Review* 311, 313 (1991). Most of the information in this section was gleaned from this article. See generally Arthur E. Brunck et al., *Ocean Marine Insurance* (1988).
- 29 Additional coverage can be added through a war and riot risk clause and an Inchmaree clause.
- 30 Assured refers to the party insured by the policy. Assurer refers to the insurance company.
- 31 Cargo may be voluntarily sacrificed by jettison in the common good, giving rise to a general average loss.
- 32 Letters of mart or marque are government authorizations to commit piracy against a designated state or person.
- 33 Barratry is fraud or criminal conduct performed by the captain or the crew.
- 34 Hayden and Balick at 325.
- 35 51 U.S. 270 (1850).

DOCUMENTARY TRANSACTIONS

There are a number of methods of organizing an international sale of goods transaction. This chapter will focus on the **documentary collections transaction**, which is one of the common methods of mitigating the two main international sales risks—the seller-exporter’s risk of nonpayment for delivered goods and the buyer-importer’s risk of not receiving goods for which it has made payment. It does this by changing the sale of goods transaction to a sale of documents. In this way the buyer does not receive the documents to take control of the goods until making payment. In the same way, the seller does not give up the controlling documents without receiving payment. To accomplish this exchange while the goods are in transit to the buyer, the use of trusted third parties is required. Commercial banks located where the seller and buyer are located provide the role of “escrow agents,” collecting the documents from the seller and exchanging them for the payment provided by the buyer.

The remaining risk is the case where the buyer fails to show up to receive and pay for the documents. While the seller remains in control of the goods, it will have to incur expenses in finding a new buyer, retrieving the goods from a distant country, and, in the worst case, to write-off the entire value of the goods. In order to eliminate the seller’s payment risk, the seller may require the buyer to provide a letter of credit from a commercial bank that guarantees payment to the seller. The letter of credit (issued by buyer’s bank) may also be guaranteed by the seller’s bank in a **confirmed letter of credit**. Chapter 15 will explain the use of letters of credit in what is known as the **documentary credit transaction**.

Figure 14.1 *Focus on Transactions*: “Methods of Payment Risk Scale” shows the different methods of payment on a risk scale from the perspective of the exporter-seller and importer-buyer, with payment in advance being the most pro-exporter (seller) and open account as the most pro-importer (buyer). The most pro-buyer method is the purchase of goods by **open account** or on-account. In this method, the seller ships the goods on credit and transfers title to the buyer without receiving payment until some time after delivery, such as net 30 or 60 days. One variation of the on-account method is the *consignment of goods* transaction, which is a bit less risky for the seller. A consignment of goods is the same as the on-account transaction (delivery of goods before payment) but the seller retains title to the goods. The buyer acts as an intermediary between the seller–consignor and the buyer, obtaining payment from the ultimate buyer and title from the seller. In both the on-account and consignment methods, the risk of nonpayment rests with the seller.

The most pro-seller method is the **cash in advance** transaction. In this case, the buyer pays in advance and then awaits delivery of the goods. This method places the risk of nondelivery with the buyer, that is, paying for goods that are never delivered. In order to eliminate the seller’s payment risk and the buyer’s delivery risk, the safest and most commonly used methods in international trade are the documentary collections and documentary credit methods. Figure 14.1 also shows that under the documentary collections and documentary letter-of-credit transactions, two different times for payment are possible. If the seller wants to be paid immediately, then it would demand **payment against documents**, meaning that it will provide a **sight draft**, which requires the buyer to make payment when obtaining the documents. See Figure 14.2 *Focus on Transactions*: “Sight Draft.” An alternative known as **payment against acceptance** is used when the seller allows the buyer additional time to make payment after receiving and accepting the documents. It does this by providing a **time draft** that states a time after the

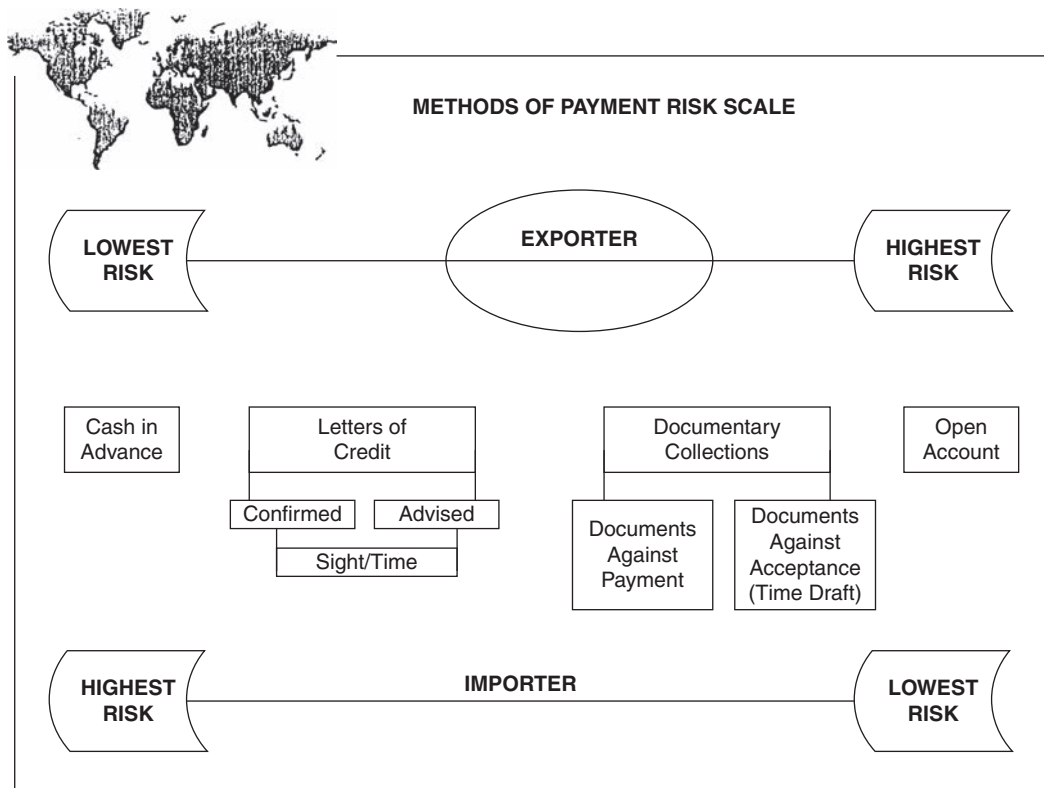


Figure 14.1 Focus on Transactions: Methods of Payment Risk Scale.

delivery in which the buyer must make payment. The sight draft in Figure 14.2 can easily be converted into a time draft by inserting a number of days in the blank in the line: “SIGHT Days After _____.”

The rest of this chapter examines the documentary sales transactions by focusing on the common documents in international sales transactions, including the key title document known as the **bill of lading**. It will also examine a key term found in all international sales contracts known as the trade term. Trade terms allocate between the seller and buyer, the costs of freight, insurance, loading and unloading of the goods, customs clearance, and the payment of fees and tariffs at the country of importation. The terms used in almost all international contracts are those that are defined by the International Chamber of Commerce’s manual entitled *INCOTERMS 2010*.

As noted above, the two fundamental risks of international exporting are the seller’s payment risk and the buyer’s delivery risk. The seller fears relinquishing control over its goods before receiving payment, while the buyer fears making payment before obtaining possession of the goods. The method of payment agreed to by the two parties determines who will bear the burden of these two risks. For sales within a country, if the buyer has good credit, sales are usually made on open account; if not, cash in advance is required. There are several basic methods of payment for products sold abroad. As with domestic sales, a major factor that determines the method of payment is the seller’s level of trust in the buyer’s ability and willingness to pay. This chapter begins with a review of the different methods of payment utilized in the sale of goods. It will then focus on the most common method of payment in international transactions—the documentary collections transaction.


		November 26 19 ____
		SIGHT DAYS AFTER ____
PAY TO THE ORDER OF	Ourselves	\$ 22,000.00
Twenty Two Thousand		DOLLARS
FOR VALUE RECEIVED AND CHARGE TO ACCOUNT OF CITIBANK LETTER OF CREDIT NO.		10076312
bank, N.A. 111 WALL STREET NEW YORK, NY	 Arthur's Clothes for Export Inc.	

Figure 14.2 Focus on Transactions: Sight Draft.

Source: Wikimedia Commons.

The common methods of payment in international trade, ranked in order from the least secure for the exporter-seller are: (1) open account and consignment sales, (2) documentary collection, (3) documentary credit, and (4) cash in advance. Since getting paid in full and on time is of utmost concern to exporters, exporters should carefully weigh these different methods of payment. For example, the buyer would much prefer an on-account or open account transaction in which she will not have to make payment until sometime after the delivery of the goods. In an open account transaction, the exporter simply bills the customer, who is expected to pay under agreed terms at a future date. Open account sales do pose risks. The exporter may have to pursue collection abroad, which can be difficult and costly. Also, receivables may be harder to finance, since drafts or other evidence of indebtedness are unavailable. In a foreign transaction, an open account is a satisfactory method of payment if the buyer is well established, has demonstrated a long and favorable payment record, or has been thoroughly checked for creditworthiness.

In contrast, cash in advance before shipment is the most desirable method from the perspective of the seller. The seller is relieved of all collection problems and has immediate use of the money, especially if a wire transfer is used. An intermediate form of cash in advance is the **consignment sale**. In international consignment sales, the buyer receives use of the goods, but title remains with the seller until the goods are sold to a third party. This method is most common when goods are shipped to a foreign distributor to be sold on behalf of the exporter. The exporter retains title to the goods until the distributor sells them. Once the goods are sold, payment is sent to the exporter. With this method, the exporter accepts a great deal of risk and loss of control over the goods and may have to wait quite a while to get paid. When this type of sale is contemplated, it may be wise to consider some form of risk insurance.

The other methods of payment lie between the two extremes of open account and cash in advance. The two most common come under the label of documentary transactions. Documentary collections and documentary credit transactions are the two forms of documentary transactions. The documentary collections transaction is the focus of this chapter. The documentary credit transaction, the use of letters of credit to guarantee payment to the seller, will be the subject of Chapter 15. Both methods involve the use of documents to ensure the passage of title to the goods to the buyer and payment to the seller while the goods are in transit.

A documentary collections transaction is one in which the buyer is obligated to pay upon delivery of documents (not delivery of goods). The documentary credit transaction also requires payment upon delivery of documents, but that payment is further guaranteed by a commercial bank through the issuance of a letter of credit. The buyer receives payment through the letter of credit upon presentation of documents to the bank. The next section will briefly discuss the above methods of payment, before examining the documentary collections transaction in-depth.

Methods of Payment

Figure 14.1 *Focus on Transactions*: “Methods of Payment Risk Scale” above lists the different methods of payments on a risk scale from the perspective of the exporter-seller and importer-buyer, with payment in advance being the most pro-exporter (seller) and open account as the most pro-importer (buyer).

Open Account

An open account transaction is a sale where the goods are shipped and delivered before payment is due, which in international sales is typically in 30, 60, or 90 days. This is the most pro-buyer-importer in terms of managing cash flow and costs, while it provides the highest risks to the exporter. Buyers often ask exporters for open account terms since the extension of credit by the seller is common in domestic transactions, especially with repeat customers. The seller should only consider the open account method for known and trusted buyers. However, in a competitive marketplace, a seller that offers open account terms will have an advantage over its competitors who do not. The open account transaction is a form of seller financing in that the buyer often resells the goods and obtains payment before the time comes due for paying the seller. Ways of minimizing the risk of nonpayment under open account terms include: (a) export working capital financing, (b) government-guaranteed export working capital programs, (c) export credit insurance, and (d) export factoring. US government agencies offer working capital financing and guarantees, as well as export credit insurance. Export factoring involves selling your open accounts (account receivables) to a factoring company who assumes the responsibility for collecting payments owed. Factoring will be discussed in Chapter 15.

Cash in Advance

In the situation where the seller has superior bargaining power, especially in cases where its goods are in high demand and the buyer is a new customer, it will demand payment in advance before shipping the goods to the buyer. For international sales, wire transfers and credit cards are the most commonly used cash-in-advance payment options. However, escrow services via the Internet are becoming another cash-in-advance option for small export transactions. Cash in advance is the least preferred method for the buyer since it has a negative effect on buyer's cash flow and the buyer assumes the risk of the seller not delivering the goods.

As noted in the open account, demanding cash in advance and not offering an open account makes a seller less competitive. Nonetheless, the seller should demand cash in advance in the following cases: (1) importer is a new customer or is not well established; (2) importer's creditworthiness is doubtful, unsatisfactory, or unverifiable; (3) political and commercial risks of the importer's home country are high; and (4) seller operates an Internet-based business where the acceptance of credit card payments is common. Because international credit card transactions are typically placed using the web, telephone, or fax, which facilitate fraudulent transactions, proper precautions should be taken to determine the validity of transactions before the goods are shipped. Credit card payment is a reasonable method for small consumer goods transactions, but in larger transactions a wire transfer is the most secure and least risky method of payment. An international wire transfer is commonly used and is almost immediate. Exporters should provide clear routing instructions to the importer when using this method, including the receiving bank's name and address, SWIFT (Society for Worldwide Interbank Financial Telecommunication) code, and bank account number.

In order to minimize the importers' delivery risk, exporters may also select escrow services as a mutually beneficial cash-in-advance option for small transactions with importers who demand assurance that the goods will be sent in exchange for advance payment. In such a scenario, the importer sends payment through a trusted third party or escrow agent. After the escrow agent verifies payment, the exporter ships the goods. When the importer receives and accepts the goods, the funds are released by the escrow service to the exporter. International commercial banks are commonly used as escrow agents.

From the exporter's perspective, payment by check is the least favorable method of cash in advance since in international transactions it may take weeks before the check clears (money collected). If the seller sends the goods before the check clears, the seller assumes the risk that the check is returned for insufficient funds. However, if the check is in U.S. dollars and drawn on a U.S. bank, the collection process is the same as it would be for any U.S. check. However, funds deposited by nonlocal checks, especially those totaling more than \$5,000, may not become available for withdrawal for up to ten business days.

Consignment

Consignment in international trade is a variation of open account in which payment is sent to the exporter only after the foreign distributor has sold the goods to the ultimate purchaser. An international consignment transaction is based on a contractual arrangement in which the foreign distributor receives, manages, and sells the goods for the exporter who retains title to the goods until they are sold. In the consignment arrangement, the exporter has the risk of not receiving payment, such as when the goods are not sold or when they are fraudulently transferred to a third party. Consignment has the advantage of keeping legal title in the exporter and allows for faster delivery of goods. It also reduces the exporter's costs of storing and managing inventory. The key to success in exporting on consignment is to partner with a reputable foreign distributor. The exporter should obtain appropriate insurance, which should be in place to mitigate the risk of nonpayment as well as to cover consigned goods in transit or in possession of a foreign distributor.

Documentary Collections

A documentary collection is a transaction whereby the exporter entrusts the collection of the payment for a sale to its bank (remitting bank), which sends the documents to the importer's bank (collecting bank) with instructions to release the documents to the buyer for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for the documents. Documentary collections transactions involve using a **bank draft** that requires the importer to pay the face amount either at sight (document against payment) or on a specified date after receiving the documents (document against acceptance). The collection letter gives instructions that specify the documents required for the transfer of title to the goods. Documentary collections are less expensive than transactions involving a letter of credit (documentary credit transactions). The term *draft* is used commonly in the United States, while **bill of exchange** is the term used in the United Kingdom and some other Commonwealth countries. The documentary collections transaction will be discussed below, while the documentary credit transaction, which is a documentary transaction with the added feature of a documentary credit (letter of credit) obtained from a bank to guarantee payment to the seller, will be reviewed in Chapter 15.

International Sales Contract

In international trade, the sales contract is the core of the export–import transaction. It is, however, always supported by other related contracts, reflecting the complexity of the transaction and the number of parties involved. First, there is the carriage contract with a shipping company to transport the goods (generally by sea). Second, there is the contract for marine insurance. Third, the sale is usually financed by means of a banking transaction, often in the form of a letter of credit.

Although not a legal issue, a business contemplating exporting for the first time must educate itself on the different cost factors related to international sales transactions. Of course, some of these additional expenses are related to the legal requirements found in the sales contract, such as the procurement of necessary documents, selecting the proper trade term (allocation of costs of shipping goods), and the need to obtain insurance. It is necessary to know these cost factors to determine the marketability of goods in a foreign market, in negotiating the sales contract, and in determining ways of mitigating the risks of loss. All additional expenses need to be incorporated into the contract price.

Pricing Goods for Export

Before exporting to or entering a foreign market, an analysis of the factors that relate to the profitability of such an entry should be undertaken. Many new exporters calculate their export price by the **cost-plus method** alone. In the cost-plus method of calculation, the exporter starts with the domestic manufacturing cost and adds administration, research and development, overhead, freight forwarding, distributor margins, customs charges, and profit. The net effect of this pricing approach may be that the export price escalates into an uncompetitive range.

A more competitive method of pricing for market entry is what is termed **marginal cost pricing**. This method considers the direct, out-of-pocket expenses of producing and selling products for export as a floor beneath which prices cannot be set without incurring a loss. For example, export products may have to be modified for the export market to accommodate different sizes, electrical systems, or labeling requirements. Changes of this nature may increase costs. On the other hand, the export product may be a stripped-down version of the domestic product and therefore cost less. Or, if additional products can be produced without increasing fixed costs, the incremental cost of producing additional products for export should be lower than the average production costs for the domestic market only.

In addition to production costs, overhead, and research and development, other costs should be allocated to domestic and export products in proportion to the benefit derived from those expenditures. Additional costs often associated with export sales include: (1) market research and credit checks; (2) business travel; (3) international postage, cable, and telephone rates; (4) translation costs; (5) commissions, training charges, and other costs involving foreign representatives; (6) consultant and freight forwarding costs; and (7) product modification and special packaging.

As in the domestic market, demand in the foreign market is a key to setting prices. What will the market bear for a specific product or service? For most consumer goods, per capita income is a good gauge of a market's ability to pay. Per capita income for most of the industrialized nations is comparable to that of the United States. For the rest of the world, it is much lower. In lower per capita income markets, simplifying the product to reduce selling price may be the answer. The exporter must also keep in mind that currency valuations alter the affordability of the goods. Thus, pricing should accommodate fluctuations in currency and the relative strength of the dollar. Few companies are free to set prices without carefully evaluating their competitors' pricing policies. Where many competitors are servicing a particular foreign market, the exporter may have little choice but to match the going price in order to establish a market share. If the exporter's product or service is new to a particular foreign market, it may actually be possible to set a higher price than is normally charged domestically. Only after it has estimated the cost, demand, and competition for its goods is the exporter-seller ready to prepare a *pro forma* invoice and enter into an export contract.

Pro Forma Invoice and Price Quotations

The prudent exporter realizes the importance of entering into a well-defined agreement. When the parties are from different countries, setting up the transaction clearly in advance is vital. First, the imposition of larger geographical distances, along with customs regulations and special documentary requirements, makes the international sale of goods transaction more complicated. Second, the exporting and importing transaction requires the use of various third parties, such as commercial banks, international common carriers, custom brokers, and freight forwarders. Thus, before entering into an international sales contract, the seller should consider the costs associated with these two factors. The form that describes the allocation of these costs between the seller and the buyer is the seller's *pro forma* invoice.

Many export transactions, particularly first-time export transactions, begin with the receipt of an inquiry from abroad, followed by a request for a quotation or a *pro forma* invoice. The *pro forma* invoice is an invoice provided by a seller prior to the shipment of goods, informing the buyer of the kinds and quantities of goods and their costs. It is generally the basis for the formation of the sales contract, along with the buyer's purchase order. A *pro forma* invoice describes the product, states a price for it, sets the time of shipment, and specifies the sale and payment terms. Before preparing the *pro forma* invoice, the prudent exporter or importer should develop a checklist of the important terms and documentary requirements that need to be incorporated. An example is provided in Figure 14.3

<p style="text-align: center;">Commercial Invoice</p> <ul style="list-style-type: none"> • Will a commercial invoice suffice or is a customs or consular invoice required? • Are all charges in accord with the original quotation? • Are terms of delivery clear? Were INCOTERMS 2010 used? • Are terms of payment and currency of payment clearly stated? • Are unit descriptions, measures, and prices recorded the same way as on all other documents? Are they exactly as required by the letter of credit? • Is a destination control statement required? <p style="text-align: center;">Packing List</p> <ul style="list-style-type: none"> • Are shipper and consignee clearly identified? • Are all item descriptions and units of measure per the commercial invoice and the letter of credit? • Are carton marks and numbers accurate? • Does the packing list conform to the importing country's requirements? <p style="text-align: center;">Shipper's Export Declaration (SED)</p> <ul style="list-style-type: none"> • Is an SED required? • Has the correct export license designation been used? Is a validated export license required? 	<ul style="list-style-type: none"> • Have the commodity, consignee, and destination country been reviewed for export controls? <p style="text-align: center;">Bill of Lading</p> <ul style="list-style-type: none"> • Are the consignee, shipper, and notify party clearly identified? • Do descriptions, marks, and numbers match the commercial invoice and packing list? • Are ocean bills of lading marked "On Board" if required by letter of credit? • If freight charges are included on the commercial invoice, is the bill of lading marked "Prepaid"? • Are any of the items classifiable as hazardous materials? <p style="text-align: center;">Certificate of Origin</p> <ul style="list-style-type: none"> • Is an origin certificate required by the letter of credit or by the destination country? <p style="text-align: center;">Miscellaneous Documents</p> <ul style="list-style-type: none"> • Preshipment inspection certificate? • Insurance certificate? • Manufacturer's certificate? • Phytosanitary inspection certificate? • Weight certificate?
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Figure 14.3 *Focus on Transactions*: International Shipping Checklist.

Focus on Transactions: "International Shipping Checklist." Figure 14.4 *Focus on Transactions* provides a list of "Common Documents" used in international sales.

Since the foreign buyer may not be familiar with the product, the description of it in the *pro forma* invoice must be more detailed than it would be in a domestic quotation. The description should include: (1) buyer's name and

<ul style="list-style-type: none"> • <u>Certificate of Origin (COO)</u>: Signed statement required in certain nations attesting to the origin of the export item. North American Free Trade Agreement (NAFTA) certificate of origin is required for products traded between the Canada, Mexico, and the United States when lower tariff duty is claimed for NAFTA qualified goods. • <u>Certificate of Conformity</u>: Signed statement from a manufacturer attesting that a product meets certain technical standards. • <u>Commercial Invoice</u>: Document prepared by the exporter or freight forwarder and required by the foreign buyer to prove ownership. In most cases, the commercial invoice is used to assess customs duties. • <u>Consular Invoice</u>: Document required in some countries that describes the goods being shipped and is certified by the consular official of the foreign country stationed in the country of export. • <u>Customs Declaration</u>: Document that describes the nature of the goods, value, consignee, and the ultimate destination required for statistical purposes. 	<ul style="list-style-type: none"> • <u>Customs Invoice</u>: Document used to clear goods through customs in the importing country by providing evidence of the value of goods. In some cases, the commercial invoice may be used for this purpose. • <u>Packing List</u>: List that itemizes the exported material in each package and indicates the type of package, such as a box, crate, drum, or carton. • <u>Inspection Certificate</u>: Document prepared by a third party to attest to the specifications of the goods shipped. • <u>Insurance Certificate</u>: Document prepared by the exporter or freight forwarder that provides evidence that the goods are insured against loss or damage the goods. • <u>Pro Forma Invoice</u>: Invoice prepared by the exporter before shipping the goods, informing the buyer of the goods to be sent, their value, and other key specifications. • <u>Shipper's Export Declaration (SED)</u>: Document used to control exports and act as a source document for official U.S. export statistics. SEDs are required for shipments when the value of the commodities is more than \$2,500.
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Figure 14.4 *Focus on Transactions*: Common Documents.

address; (2) buyer's reference number and date of inquiry; (3) list of requested products and brief description; (4) price of each item (it is advisable to indicate whether items are new or used and to quote in U.S. dollars to reduce foreign-exchange risk); (5) gross and net shipping weight (in metric units where appropriate); (6) total cubic volume and dimensions (in metric units where appropriate) packed for export; (7) trade discount, if applicable; (8) delivery point; (9) terms of sale; (10) terms of payment; (11) insurance and shipping costs; (12) validity period for quotation; (13) total charges to be paid by customer; (14) estimated shipping date from factory or U.S. port; and (15) estimated date of shipment arrival.

The *pro forma* invoice should not be confused with the commercial invoice. *Pro forma* invoices are not for payment purposes but are essentially quotations in an invoice format. The invoice should be conspicuously marked "*pro forma* invoice." It is important that price quotations state explicitly that they are subject to change without notice. If a specific price is agreed upon or guaranteed by the exporter, the precise period during which the offer remains valid should be specified.

Pro Forma Invoice versus Commercial Invoice: A *pro forma* invoice or "sample invoice" is created prior to the entering of a sales contract. It is often used as a contractual offer that the buyer may accept to form a contract. The *pro forma* invoice is replicated in the final commercial invoice so that the buyer is not surprised by any variation in the goods or the price. The *pro forma* invoice can be used to obtain the import license or a foreign exchange permit. The commercial invoice is one of the required documents in a documentary transaction. It provides a detailed description of the goods, including prices, discounts, quantity, delivery, and payment terms. The commercial invoice is used by governments to determine the value of the goods for the assessment of customs duties.

Documentary Collections Transaction

In order to alleviate the seller's risk of not being paid or the buyer's risk of not receiving the goods after making payment, most export contracts require a documentary transaction. The sale of goods contract is converted into a sale of documents contract. The buyer contracts to buy documents and the seller promises to provide conforming documents to the buyer while the goods are in transit. In the documentary transaction, the seller is paid and the buyer receives title to the goods while the goods are in transit to the port of destination. In this way, the buyer's delivery and seller's payment risks are diminished. Upon receiving the documents, the buyer is in a position to resell the goods to downstream buyers or to use the documents as collateral to obtain financing. In the event that the buyer refuses to pay for the documents, the seller still retains title and control of the goods. He can mitigate his losses by selling the goods to someone else through negotiation of the documents.

One of the key documents in the documentary collections transaction is the **draft**. The banks use this instrument to effectuate payment to the seller upon the presentation of the documents. A draft or bill of exchange is analogous to a foreign buyer's check. A draft is a written, unconditional order for payment from the **drawer** (seller) to the **drawee** (buyer). It directs the drawee to pay a specified sum of money, in a given currency, at a specific date to the payee (seller). Drafts that are paid when presented for payment are called sight drafts. *Sight* refers to the presentation of the required documents to the location stated in the contract, which is usually at the transmittal of the documents to the buyer's bank. Drafts that are payable at some time after presentation of the documents are called time drafts.

The documentary collections transaction allows the buyer to take possession either by making payment upon the presentation of the draft or by acceptance of the draft. The first type of documentary collections transaction is called **Cash against Documents**. This type is the ordinary means of processing a documentary collections transaction. The "documents against payment" transaction uses a sight draft, which allows the exporter to retain title to the shipment until payment has been made.

The second type of documentary collections transaction is referred to as the **Cash against Acceptance** type of documentary collections. The Cash against Documents transaction requires the buyer to sign a sight draft before receiving the necessary documents. The sight draft is then processed through the banking system for immediate

payment to the seller. In the Cash against Acceptance transaction, instructions are given by the seller to a bank indicating that the documents transferring title to the goods should be delivered to the buyer–drawee upon the buyer’s acceptance of the attached time draft. The buyer’s signature indicates its guarantee to pay the draft at some future time. The function of drafts as means of payment and as used for purposes of financing are discussed in detail in Chapter 15.

Document Against Acceptance Collection: A document against acceptance collection, also known as a time draft, is used when the exporter extends credit to the buyer. By signing and writing “accepted” on the draft, the buyer is formally obligated to pay within the stated time. When this is done, the time draft is then called a trade acceptance. A date draft differs slightly from a time draft in that it specifies a date on which payment is due, rather than a time period after acceptance of the draft. When either a sight draft or a time draft is used, a buyer can delay payment by delaying acceptance of the draft. A date draft can prevent this delay in payment.

The main responsibilities of the exporter and importer in the documentary credit transactions in chronological order are as follows: (1) enter into a sale contract; (2) importer obtains letter of credit; (3) exporter receives confirmation of issuance of the letter of credit; (4) hire carrier for transport of goods; (5) obtain necessary insurance policies; (6) arrange inspection of goods prior to shipment; (7) prepare goods for shipment: packing, marking; (8) exporter delivers goods to common carrier and acquires bill of lading; (9) exporter obtains other shipping documents; (10) exporter transmits shipping documents (delivery to bank); (11) importer receives documents and payment is made under the letter of credit; (12) goods are cleared through customs clearance in the country of delivery; and (13) final liquidation of customs duties and delivery to importer.

Enlisting the services of commercial banks to transfer documentation (10) is a common requirement of the standard sales contract (1). Following the receipt of the letter of credit, the seller will prepare the goods for shipment (7) and obtain an insurance policy to cover the risk of loss to the goods while they are being transported to the buyer (5). In order to diminish the risk of fraudulent documentation, a prudent buyer will negotiate for inspection rights (6). The inspection of the goods will take place before the goods are loaded at the port of shipment. The inspection company issues an inspection certificate that the seller sends to the buyer, along with the other required documents. The buyer will be able to review the inspection report before paying for the documents and taking possession of the goods at the port of destination.

The international sales contract almost always provides for transit of the goods by ocean carriage. Under the standard **CIF** (Cost, Insurance, Freight) contract, for example, the seller must ship the goods by obtaining the services of a freight forwarding company and a common carrier to transport the goods to the buyer (4). The contract will require that the seller obtain a bill of lading from the common carrier to prove that the goods have been sent as dictated by the contract (8 and 9). The seller will not be able to receive payment unless it delivers to the bank for transmission to buyer a conforming bill of lading, along with the other documents stated in the sales contract (10). After the bank reviews the documents the seller receives payment (11). Upon receipt of the bill of lading and other documents the buyer is then able to take delivery of the goods for import into the country (12 and 13).

As discussed previously, the seller in a documentary collections transaction is required to present a number of conforming documents as required in the sales contract in order to receive payment. The required documents are generally attached to a draft or bill of exchange. The seller draws the draft on the account of the buyer and makes it payable to the seller. Unlike with a standard check or bank draft, the seller is both the drawer and payee of the documentary draft. To better reduce the payment risk, the seller (exporter) will want to negotiate a sight draft so that it will receive payment immediately upon the presentation of the documents. Some exporters, however, will agree to wait for payment, especially when doing business with an established customer. In such cases, a time draft is utilized that provides for payment within so many days of presentment or from shipment. In that case, the buyer should be required to sign and note “accepted” on the time draft before obtaining possession of the documents.

The typical documentary collections transaction proceeds along a chronological timeline. It begins with the negotiation and execution of a sales contract. The sales contract is usually formed by the exchange of a *pro forma* invoice or price quotation from the seller and a purchase order from the buyer. The sellers often contact freight forwarders to obtain freight quotes and insurance information before drafting the *pro forma* invoice. After the contract is formed, the seller contacts the freight forwarder to book shipment on a common carrier. The freight forwarder coordinates the movement of the goods, submits the export documentation to the Customs Service, obtains the bill of lading from the carrier, and compiles other required documents.

The bill of lading is a title document (see Figure 14.5 *Focus on Transactions*: “Bill of Lading”) that allows the goods to be transferred while they are in transit to the port of destination. Without the bill of lading, or similar title document, the documentary transaction would not be possible. The bill of lading allows a sale of goods transaction to be converted to a sale of documents. Upon receiving the bill of lading, the buyer becomes the owner of the goods. Any dispute over the ownership of goods will be resolved in favor of the party in possession of the bill of lading and not the party in the actual possession of the goods. The functions and characteristics of the bill of lading will be reviewed in detail later in this chapter.

In order to obtain the bill of lading, the goods are delivered to the common carrier. The bill of lading is endorsed by the shipper and sent via the shipper’s bank to the buyer’s bank or to another intermediary along with a sight draft, invoices, and other supporting documents specified by the buyer, such as packing lists, consular invoices, and insurance certificates. The seller usually does not submit the documents and draft directly to the buyer’s bank. Instead, it uses a local bank to transmit the documents through its corresponding relations to the buyer’s bank. These documents are presented to the buyer’s bank along with a documentary collections letter or order. The collection letter or order includes a draft drawn on the buyer’s account either payable at sight or at a future time.

The buyer’s bank acts as the collecting bank for purposes of transmitting payment to the seller. It notifies the buyer of the receipt of the documents and collects payment on the draft (sight draft) or notifies the seller of the buyer’s acceptance of the draft (time draft). Following the payment or acceptance, the bill of lading and other documents are released to the buyer. Before the cargo can be released, the original ocean bill of lading must be properly endorsed by the buyer and surrendered to the carrier, since it is a document that evidences title. Air waybills of lading, on the other hand, do not need to be presented in order for the buyer to claim the goods. The buyer transmits the shipping documents to its customs broker. The customs broker clears the goods through customs at the port of importation and arranges inland transport to the buyer’s warehouse. Finally, funds are wired through the banking system to the seller’s account. If the sales contract requires the purchaser to guarantee payment through a letter of credit, then the first step in the process is the procurement by the buyer of a letter of credit. The role of letters of credit in international business transactions will be examined in Chapter 15.

Documents in the Documentary Transaction

The following documents are commonly used in exporting; which of them are actually used in each case depends on the requirements of the exporting and importing countries. First, as in a domestic transaction, the **commercial invoice** is a bill for the goods prepared by the seller. A commercial invoice contains basic information about the transaction, including a description of the goods, the address of the buyer and seller, and the delivery and payment terms. The buyer needs the invoice to prove ownership and to arrange payment. Some governments use the commercial invoice to place a value on the goods in assessing customs duties.

Second, the bill of lading serves as a contract between the shipper of the goods and a common carrier. It is a receipt or evidence that the goods were received and placed in the control of the common carrier in good condition, and, most importantly, it is a document of title. A negotiable or shipper’s order bill of lading can be bought, sold, or traded while goods are in transit and is used for letter-of-credit transactions. Without the bill of lading or a similar document, there could not be a documentary transaction since it provides the means of transferring ownership to the goods while they are in transit to the place of destination. A straight bill of lading

Original — Not Negotiable

Shippers No. _____

Carrier's No. _____

(Name of Carrier) _____

Received, subject to the classifications and tariffs in affect on the date of the issue of this Bill of Lading

19 From _____

the property described below, in apparent good order, except noted (contents and condition of contents of packages unknown), marked, consigned, and destined as indicated below, which said carrier (the word carrier being understood throughout this contract as meaning any customer or corporation in possession of the property under contract) agrees to carry to its usual place of delivery at said destination, if on its route, otherwise to deliver to another carrier on the route to said destination. It is mutually agreed, as to each carrier of all or any said property over all or any portion of said route to said destination and as to each party at any time interested in all or any of said property, that every service to be performed hereunder shall be subject to all the terms and conditions of the Uniform Domestic Straight Bill of Lading set forth (1) in Official, Southern, Western and Illinois freight classification in affect on the date hereof, if this is a rail or a rail-water shipment or (2) in the applicable motor carrier classification or tariff if this is a motor carrier shipment.

Shipper hereby certifies that he is familiar with all the terms and conditions of the said bill of lading, including those on the back thereof set forth in the classification or tariff which governs the transportation of this shipment, and the said terms and conditions are hereby agreed by the shipper and accepted for himself and his assigns.

Consigned to

Destination State Country (Mail or street address of consignee — for purpose of notification only.) Delivery address ★
Route (★ To be filled in only when shipper desires and governing tariffs provide for delivery thereat.)

Delivery Carrier Car or Vehicle initials No.

No. Packages	Kind of Package, Description of Articles, Special Marks, and Exceptions	* Weight (Subject to Correction)	Class or Rate	Check Column	C.O.D. charge to be paid by { Shipper <input type="checkbox"/> Consignee <input type="checkbox"/>
					Subject to section 7 of Conditions of applicable bill of lading. If this shipment is to be delivered to the consignee without recourse on the consignor, the consignor shall sign the following statement: The carrier shall not make delivery of this shipment without payment of freight and all other lawful charges.
					(Signature of consignor)
					If charges are not to be prepaid, write or stamp here, "to be prepaid."
					Received \$ _____ to apply in prepayment of the charges on the property hereon.
					Agent or Cashier
					Per _____ (The signature here acknowledges only the amount prepaid.)
					Charges Advanced:
					\$ _____
<p>* If the shipment moves between two ports by a carrier by water, the law requires that the bill of lading shall state whether it is carrier's or shippers weight NOTE — Where the rate is dependent on the value, shippers are required to state specifically in writing the agreed or declared value of the property. The agreed or declared value of the property is hereby specifically stated by the shipper to be not exceeding _____ per</p>					<p>Shippers imprint in lieu of stamp; not a part of Bill of Lading approved by the Interstate Commerce Commission.</p>
<p>This is to certify that the above named articles are properly classified, described, packaged, marked and labeled, are in the proper condition for transportation, according to the applicable regulations of the Department of Transportation.</p>					<p>The fibre boxes used for this shipment conform to the specifications set forth in the box maker's certificate thereon, and all other requirements of the Consolidated Freight Classification.</p>
Shipper, Per _____					Agent, Per _____

Figure 14.5 Focus on Transactions: Bill of Lading.

Source: Claudio Elias, Wikimedia Commons.

is nonnegotiable. The customer usually needs the original bill of lading to take possession of the goods. See Figure 14.5 *Focus on Transactions*: “Bill of Lading” for a common example of a bill of lading. Note that the bill of lading is mostly blank space with the most important part being the areas for inserting the description of the goods, kind of package, number of packages, weight when appropriate, and marking requirements. Often the exporter or its agent (freight forwarder) prepares the description for the bill of lading since the common carrier (shipping company) receives the goods in sealed steel containers. However, under international carriage conventions (see Chapter 13), the common carrier is a guarantor of the description on the bill of lading even if it proves to be false or fraudulent.

Bearer Document: The negotiable bill of lading is considered a bearer document, similar to other financial instruments like bearer bonds. A holder of the instrument is paid or takes possession of goods immediately upon presentation of the document. This is why common carriers can only deliver the goods to a party holding the bill of lading, even though that party is not the rightful buyer. This is also the reason that the buyer should demand receipt of the “full set” of the bill of lading. Each copy of the bill of lading is a bearer document. However, if the bill of lading is made out or endorsed to a specific person or company, then only that person or company is entitled to receive delivery of the goods. A bill of lading that has a blank endorsement is transformed into a bearer instrument.

Third, certain countries require a **consular invoice**, which is used to control and identify goods. The consular invoice is purchased from the consulate of the country to which the goods are being shipped and usually must be prepared in the language of that country. Fourth, some countries require a signed statement as to the origin of the export item. Such **certificates of origin** are usually obtained through a semiofficial organization such as a local chamber of commerce. In addition, free trade areas will have their own certificate of origin forms. These forms only need to be submitted if the importing party elects to take advantage of the lower tariff rates offered under the free trade agreement. In order to do so, the goods being imported must be coming from a country within the free trade area and meet minimum levels of regional content (see Figure 14.6 *Comparative Law*: “NAFTA Certificate of Origin”).

Fifth, some purchasers and countries may require a **certificate of inspection** attesting to the specifications of the goods shipped. Inspection certificates are often obtained from independent testing organizations. Sixth, if the seller provides insurance, then he must provide an **insurance certificate** or binder stating the type and amount of coverage. This insurance certificate is negotiable so that it can be transferred along with the bill of lading.

Seventh, the United States requires a **Shipper’s Export Declaration (SED)**. The SED is used to control exports and compile trade statistics. It must be prepared and submitted to U.S. Customs for exports valued at more than \$2,500. See Figure 14.7 *Comparative Law*: “Shipper’s Export Declaration.” To help ensure that U.S. exports go only to legally authorized destinations, the U.S. government requires a **destination control statement** on shipping documents. Under this requirement, the commercial invoice and bill of lading for commercial shipments leaving the U.S. must display an **anti-diversion clause** notifying the carrier and all foreign parties that the products have been approved for export only to certain destinations and may not be diverted contrary to U.S. law. Eighth, U.S. export shipments are required by the U.S. government to have either a general or a validated **export license**. Most goods are exported under a general license, which merely requires the filing of an SED.

Ninth, an export **packing slip** or list itemizes the material in each individual package being shipped. It gives the individual and gross weights and measurements for each package, along with the package markings. The packing list is attached to the outside of a package in a waterproof envelope marked “packing list enclosed.” It allows the shipper or forwarding agent to determine the total shipment weight, volume, and whether the correct cargo is being shipped. In addition, customs officials use the list to check the cargo. Some of the common documents were previously listed in Figure 14.4. A more detailed listing of the common documents used in the documentary transaction is found in Figure 14.8 *Doing Business Internationally*: “List of Export Documents.”

SAMPLE NAFTA CERTIFICATE OF ORIGIN

DEPARTMENT OF THE TREASURY UNITED STATES CUSTOMS SERVICE		Approved through 12/31/96 OMB No. 1515-0204 See back of form for Paperwork Reduction Act Notice				
NORTH AMERICAN FREE TRADE AGREEMENT CERTIFICATE OF ORIGIN						
Please print or type		19 CFR 181.11 181.22				
1. EXPORTER NAME AND ADDRESS TAX IDENTIFICATION NUMBER:		2. BLANKET PERIOD (DD/MM/YY) FROM _____ TO _____ 4. IMPORTER NAME AND ADDRESS TAX IDENTIFICATION NUMBER:				
3. PRODUCER NAME AND ADDRESS TAX IDENTIFICATION NUMBER:						
5. DESCRIPTION OF GOOD(S)		6. HS TARIFF CLASSIFICATION NUMBER	7. PREFERENCE CRITERION	8. PRODUCER	9. NET COST	10. COUNTRY OF ORIGIN
I CERTIFY THAT: • THE INFORMATION ON THIS DOCUMENT IS TRUE AND ACCURATE AND I ASSUME THE RESPONSIBILITY FOR PROVING SUCH REPRESENTATIONS. I UNDERSTAND THAT I AM LIABLE FOR ANY FALSE STATEMENTS OR MATERIAL OMISSIONS MADE ON OR IN CONNECTION WITH THIS DOCUMENT; • I AGREE TO MAINTAIN, AND PRESENT UPON REQUEST, DOCUMENTATION NECESSARY TO SUPPORT THIS CERTIFICATE, AND TO INFORM, IN WRITING, ALL PERSONS TO WHOM THE CERTIFICATE WAS GIVEN OF ANY CHANGES THAT COULD AFFECT THE ACCURACY OR VALIDITY OF THIS CERTIFICATE; • THE GOODS ORIGINATED IN THE TERRITORY OF ONE OR MORE OF THE PARTIES, AND COMPLY WITH THE ORIGIN REQUIREMENTS SPECIFIED FOR THOSE GOODS IN THE NORTH AMERICAN FREE TRADE AGREEMENT, AND UNLESS SPECIFICALLY EXEMPTED IN ARTICLE 411 OR ANNEX 401, THERE HAS BEEN NO FURTHER PRODUCTION OR ANY OTHER OPERATION OUTSIDE THE TERRITORIES OF THE PARTIES; AND • THIS CERTIFICATE CONSISTS OF PAGES, INCLUDING ALL ATTACHMENTS.						
11a. AUTHORIZED SIGNATURE 11c. NAME (Print or Type)		11b. COMPANY 11d. TITLE 11e. DATE (DD/MM/YY) 11f. TELEPHONE NUMBER (Voice) (Facsimile)				

Customs Form 434 (121793)

Figure 14.6 Comparative Law: NAFTA Certificate of Origin.

U.S. DEPARTMENT OF COMMERCE E - Economics and Statistics Administration - U.S. CENSUS BUREAU		BUREAU OF EXPORT ADMINISTRATION	
FORM 7525-V (7-18-2003)		SHIPPER'S EXPORT DECLARATION	
OMB No. 0607-0152			
1a. U.S. PRINCIPAL PARTY IN INTEREST (USPPI) (Complete name and address) CONTINENTAL DUTY FREE INC. P.O. BOX 52-4183 MIAMI, FL		2. DATE OF EXPORTATION FEB 07, 2008	3. TRANSPORTATION REFERENCE NO. MIAELS028POR 007
b. USPPI's EIN (IRS) OR ID NO.	c. PARTIES TO TRANSACTION <input type="checkbox"/> Related <input checked="" type="checkbox"/> Non-related		
4a. ULTIMATE CONSIGNEE (Complete name and address) ERZULIA JOSEPH LUBIN PORT DE PAIX, HAITI			
b. INTERMEDIATE CONSIGNEE (Complete name and address) SAME AS ABOVE			
5a. FORWARDING AGENT (Complete name and address) N/A			
5b. FORWARDING AGENT'S EIN (IRS) NO. N/A		6. POINT (STATE) OF ORIGIN OR FTZ NO. FLORIDA	7. COUNTRY OF ULTIMATE DESTINATION HAITI
8. LOADING PIER (Vessel only) MIAMI RIVER	9. METHOD OF TRANSPORTATION (Specify) VESSEL	14. CARRIER IDENTIFICATION CODE LBRL	15. SHIPMENT REFERENCE NO. MIAELS028POR 007
10. EXPORTING CARRIER M/V EL SHADDAI	11. PORT OF EXPORT MIAMI, FL	16. ENTRY NUMBER	17. HAZARDOUS MATERIALS <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
12. PORT OF UNLOADING (Vessel and air only) PORT DE PAIX	13. CONTAINERIZED (Vessel only) <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	18. IN BOND CODE	19. ROUTED EXPORT TRANSACTION <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
20. SCHEDULE B DESCRIPTION OF COMMODITIES (Use columns 22-24)			
D/F or M (21)	SCHEDULE B NUMBER (22)	QUANTITY - SCHEDULE B UNIT(S) (23)	SHIPPING WEIGHT (Kilograms) (24)
D	2401.20.5592 TABACCO	300 CASES	3402 K
			VIN/PRODUCT NUMBER/ VEHICLE TITLE NUMBER (25)
			VALUE (U.S. dollars, omit cents) (Selling price or cost if not sold) (26)
			\$ 19,200
27. LICENSE NO./LICENSE EXCEPTION SYMBOL/AUTHORIZATION NLR		28. ECCN (When required)	
29. Duly authorized officer or employee CHRISTOPHER ROMERO		The USPPI authorizes the forwarder named above to act as forwarding agent for export control and customs purposes.	
30. I certify that all statements made and all information contained herein are true and correct and that I have read and understand the instructions for preparation of this document, set forth in the "Correct Way to Fill Out the Shipper's Export Declaration." I understand that civil and criminal penalties, including forfeiture and sale, may be imposed for making false or fraudulent statements herein, failing to provide the requested information or for violation of U.S. laws on exportation (13 U.S.C. Sec. 305; 22 U.S.C. Sec. 401; 18 U.S.C. Sec. 1001; 50 U.S.C. App. 2410).			
Signature		Confidential - Shipper's Export Declarations (or any successor document) whenever located, shall be exempt from public disclosure unless the Secretary determines that such exemption would be contrary to the national interest (Title 15, Chapter 9, Section 301 (g)).	
Title VESSEL AGENT		Export shipments are subject to inspection by U.S. Customs Service and/or Office of Export Enforcement.	
Date FEB 11, 2008		31. AUTHENTICATION (When required)	
Telephone No. (Include Area Code) 305-324-8350		E-mail address	

This form may be printed by private parties provided it conforms to the official form. For sale by the Superintendent of Documents, Government Printing Office, Washington, DC 20402, and local Customs District Directors. The "Correct Way to Fill Out the Shipper's Export Declaration" is available from the U.S. Census Bureau, Washington, DC 20233.

Figure 14.7 Comparative Law: Shipper's Export Declaration.

<p>Bill of Lading</p> <p>A title document issued by a shipping company. It also serves as a formal receipt of the goods and a carriage contract. The holder of the bill of lading has a right to claim delivery of the goods from the shipping company at the port of destination. The most common bill of lading in international transport is the ocean bill of lading. A multimodal transport bill of lading may be used when more than one form of transport is being used.</p> <p>Letter of Credit</p> <p>A document issued by the importer–purchaser’s bank to guarantee the payment of the draft to the exporter for the purchase of the goods or upon the presentation of documents by the exporter. A transferable letter of credit allows the exporter (beneficiary) to make the credit payable to others (suppliers).</p> <p>Letter of Indemnity</p> <p>This document allows a carrier to release goods to the consignee not yet in possession of the bill of lading. It is a guarantee to indemnify the carrier from all liability related to the release. It is also called a “steamer guarantee.”</p> <p>Export License</p> <p>A government-issued document granting permission to export a specific commodity to a specific country.</p> <p>Dock Receipt</p> <p>This document certifies the receipt of the goods by a carrier at the port of shipment.</p> <p>Warehouse Receipt</p> <p>Acknowledges receipt of the goods by a warehouse operator. A “dock warrant” not only acknowledges receipt, but is also a document of title.</p> <p>Commercial Invoice</p> <p>This document is prepared by the exporter and lists and describes the goods. It generally also gives the prices, discounts, quantities, and delivery and payment terms. It is used by governments to place a valuation of the goods for the assessment of customs duties.</p>	<p>Consular Invoice</p> <p>An invoice certified by the consul of the country of import; customs officials use it to verify the value, quantity, and quality of the goods use it. Also, the consular may compare the export price with the market price in the exporting country to determine if dumping is evident.</p> <p>Certificate of Inspection</p> <p>An independent inspection company issues a certificate of inspection to assure the purchaser of the quantity and quality of the goods being shipped. Preshipment inspection is a requirement for importation of goods into many developing countries.</p> <p>Certificate of Origin</p> <p>It is provided by a third party such as an official of the local chamber of commerce or an official of the consular office.</p> <p>Bill of Exchange or Draft</p> <p>An order addressed to the importer or the importer’s bank for the payment of a fixed sum at sight or in the future (time draft).</p> <p>ATA Carnet</p> <p>The ATA Carnet or “Merchandise Passport” is an international customs document which allows for the duty- and tax-free temporary import and export of professional equipment, commercial samples, and goods for trade shows and exhibitions. A carnet is usually good for one year from the date of issuance. Generally, a bond or cash deposit of 40 percent of the value of the goods is required. Carnets may be purchased at the U.S. Council for International Business in New York City.</p> <p>ISO 9000 Certificate</p> <p>The International Standards Organization has developed standards which certify that the exporter meets certain minimum requirements of quality.</p> <p>Marine Insurance Certificate or Binder</p> <p>Marine or cargo insurance provides protection for loss or damage while the goods are in transit.</p>
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Figure 14.8 *Doing Business Internationally*: List of Export Documents.

The number of documents the exporter must deal with varies depending on the destination of the shipment. Because each country has different import regulations, the exporter must be careful to provide proper documentation. Exporters should seriously consider having the freight forwarder handle the documentation. Much of the documentation is routine for freight forwarders or customs brokers acting on the firm’s behalf, but the exporter is ultimately responsible for the accuracy of the documentation.

Bill of Lading

The bill of lading is the traditional transport document and serves three functions: (1) carriage contract between the ship owner and the shipper, (2) evidence of receipt that the goods were delivered to the ship, and (3) document of

title (see Figure 14.5 *Focus on Transactions: “Bill of Lading”*). Its function as a title document allows for the sale, transfer, and “collateralization” of the goods while in transit. Lord Mustill in discussing the third function of the bill of lading states that “it is a symbol of constructive possession of the goods which can transfer possession by endorsement and transfer; it is a transferable *key to the warehouse*.”¹

Although the bill of lading generally serves as a document of title, receipt, and carriage contract, other agreements may preempt its role in one of these areas. For example, a prior agreement, such as a freight or booking contract, may control the contractual relationship between the shipper and the common carrier. In *M & Z Trading Corp. v. Cargolift Ltd.*,² the shipper argued that a prior freight agreement governed, while the common carrier contended that its bill of lading constituted the contract. The court reasoned that the resolution of such disputes turns on factual and legal issues relating to, for example, the parties’ negotiations, the documents generated during those negotiations, and the status and legal effect of the bill of lading. By the express terms of the prior agreement, the carrier’s general obligations began upon the initial pickup of the goods in Canada and continued until final delivery in Russia. The court held that the bill of lading could have only, at most, supplemented the parties’ prior agreement, unless the parties clearly agreed otherwise. Therefore, the bill of lading did not nullify the lengthy course of negotiations that culminated in the prior freight agreement.

A future development that will transform documentary practice is the electronic bill of lading. **Electronic bills of lading** will enable a more efficient sale or transfer of goods while they are in transit. The first electronic bill of lading was developed in conjunction with rail transport (CMI Rules for Electronic Bills of Lading). Despite technological advances, “paper” documents remain the norm in documentary collections. It is possible to send electronic letters of credit and bills of lading, but sellers continue to request written confirmation of the issuance of a letter of credit and continue to demand paper bills of lading. However, the CMI (Comité Maritime International) has adopted the Rules for Electronic Bills of Lading (CMI Rules). The CMI Rules provide the following procedure for the use of electronic bills of lading: (1) Any common carrier issuing an electronic bill of lading must also act as a clearinghouse for subsequent transfers of the electronic bill; (2) After receiving the goods, the carrier must electronically notify the shipper and provide a description of the goods and a “private key.” The holder of the key is the owner of the goods and is the only one who can transfer the goods; (3) When the seller sells the goods, she notifies the carrier and provides it with the private key. (4) The carrier then voids the private key and issues a new private key to the new holder of the bill of lading. It is certain that sometime in the future the use of electronic forms of documents will become commonplace. A more expansive project, known as the BOLERO Project, to transmit electronically all standard documents is underway.

Bolero Project: Bolero possesses a core messaging platform that allows electronic transmissions related to bills of lading (corporate-to-bank communication), bank guarantees, standby letters of credit, other documents used in documentary collections, processing of both national and international open account transactions, and expediting bank payment obligations through use of the electronic bill of lading (eBL).

Characteristics of Bills of Lading

Table 14.1 “Characteristics of the Bill of Lading (B/L)” lists the different characteristics or types of ocean bills of lading. The standard documentary sales contract requires an **on-board bill of lading**. The on-board bill of lading warrants that the cargo has been placed aboard a named vessel and is signed by the master of the vessel. This type of bill ensures the buyer that the goods are indeed on the ship in transit to the port of destination. A **received-for-shipment bill of lading** recognizes only the delivery of the goods to the common carrier; it does not warrant that the goods have been placed upon the ship.

If the sale contract is silent regarding the type of bill of lading, must the buyer accept a received-for-shipment bill of lading when presented with the documents? The answer for the U.S. exporter is different depending on whether the UCP 600³ or Article 5 of the Uniform Commercial Code (UCC) is applied. Section

Table 14.1 Characteristics of the Bill of Lading (B/L)

Nonnegotiable or Straight B/L: only deliverable to Consignee (name on B/L)	versus	Negotiable or Order B/L
Unclean (Flawed, "Claused"): common carrier writes a notation on B/L indicating damage or count of goods	versus	Clean
Received for Shipment: goods have been delivered to common carrier or shipping terminal, but not yet loaded onto ship	versus	On-board
N/A	versus	Full Set (all copies of B/L)

1-201(15) of the UCC defines a document title simply as a "bill of lading." It does not differentiate between "on-board" and "received-for-shipment." Section 1-201(6) further defines bill of lading as "a document evidencing the receipt of goods for shipment issued by a person engaged in the business of transporting or forwarding goods." Section 2-323 specifically authorizes the use of a "received-for-shipment" bill of lading in CIF or C & F contracts.⁴ In contrast, Article 23 of the UCP states that "banks will, unless otherwise stipulated in the Credit, accept a document which: (ii) indicates that the goods have been loaded on board, or shipped on a named vessel."

Bills of lading are contracts between the owner or shipper of goods and the carrier. They do not affect the contractual relationship between the seller and the buyer. The person or firm named in a bill of lading to which goods are to be turned over is the **consignee**. A **straight bill of lading** is nonnegotiable. Such a bill allows only for delivery to the named consignee in the bill. A negotiable or **order bill of lading** can be bought, sold, or traded while the goods are in transit. The order bill is also used for many types of financing transactions and will be discussed in Chapter 15. The owner needs the original bill of lading in order to take possession of the goods. A **clean bill of lading** is a receipt for goods issued by a carrier with an indication that the goods were received in "apparent good order and condition." In letter-of-credit transactions, a "Clean, On-Board, Order Bill of Lading" is necessary for the shipper to obtain payment from the bank.

Air Waybill

Most transport of goods is performed through ocean carriage. In the event of transit by air, however, the operative transport document is the **air waybill**. The air waybill is a bill of lading that covers both domestic and international flights transporting goods to a specified destination. It is a nonnegotiable instrument that serves as a receipt for the shipper. Unlike the ocean bill of lading, the air waybill does not act as a document of title. Therefore, it merely serves as a contract of carriage and a receipt for goods.

The front of the air waybill makes a number of important representations. First, unless noted otherwise, the "goods are accepted in apparent good order and condition." Second, the shipper is directed to the reverse of the form for an explanation of the carrier's "limitation of liability." Third, the shipper is provided with notice of his right to increase carrier's liability. "Shipper may increase such limitation of liability by declaring a higher value for carriage and paying a supplemental charge." Also provided is a space for the "amount of insurance" requested by the shipper. Above the signature line, the shipper is notified that he is certifying that the goods are not dangerous unless described as such. If dangerous by nature, then the shipper certifies that the goods are in "proper condition for carriage by air according to the applicable Dangerous Goods Regulation."

Trade Terms

The insertion of a **trade term** into the sales contract allows the parties to designate the point at which the costs and risks of transport are divided between the seller and buyer. The **risk of loss** allocation determines who has the responsibility for any loss or damage to the goods while they are in transit. The generic costs allocated by the trade term are the costs of freight and insurance. As a practical matter the trade term will also allocate a number of other responsibilities, including customs clearance, payment of duties, and the loading or unloading of the goods from

the common carrier. The trade term is an element in the contract of sale and can normally be found in the *pro forma* invoice. The importance of the trade term and other **risk-shifting clauses**⁵ in the international sales contract is explained in the following excerpt:

Harold J. Berman, The Law of International Commercial Transactions (*Lex Mercatoria*)

2 *Journal of International Dispute Resolution* 245–248, 276 (1988)

The Export-Import Contract

Many of the risks inherent in an international transaction can be allocated by the importer and exporter through their contract of sale, under familiar principles of contract law. . . . Out of the price-delivery term, and especially out of the term “CIF” which is probably the most widely used term in international trade contracts, has come a great deal of law. The price-delivery term defines the title to the goods, time and place of delivery, time and place of payment, importer’s right of inspection, the risk of loss or damage to the goods in transit, and the cost of transportation.

An international sales contract typically contains other risk-shifting clauses. Force majeure and other contingency clauses are added to escape liability where unforeseen circumstances prevent performance of an assumed obligation. Choice of law, choice

of forum, and arbitration clauses seek to avoid the vagaries, uncertainties, and delays of foreign litigation. The tendency to spell out in detail such matters as inspection rights and remedies for breach may also be an attempt to substitute the law of the contract for that of any national legal system.

Destination and Shipment Contracts

An importer may ask his foreign supplier to place the goods on board a vessel bound for the country of destination and to bear the risks of the voyage. Such a contract is called a “destination contract.” . . . “Shipment contracts” cast the risk of loss upon the purchaser from the moment of loading or shipment. The seller typically agrees to place the goods on board or alongside the vessel, but the risks of transit are shifted to the buyer. Typical shipment contracts include FAS, FOB, CIF, and CFR.

The trade term controls the parties’ respective obligations regarding contracting for shipping and insurance services. The trade term is also important in determining the conformity of documents in the documentary transaction. A trade term, taken from the *International Trade Terms Manual* (INCOTERMS) as published by the International Chamber of Commerce or taken from the UCC, is a three-letter acronym that allocates the cost, risk of loss, and responsibilities of transporting the goods between the seller and buyer.

In addition, the trade term affects documentary requirements. For example, the **FOB** (free on board) trade term generally dictates that the bill of lading need not show that the freight has been paid since freight costs and shipping arrangements are delegated to the buyer in a FOB contract. There are some variations recognized by most parties. For instance, the buyer can negotiate an additional services clause into a FOB contract. This clause often requires the seller to secure liner space and an insurance certificate as agent for the buyer. This type of clause acts as a compromise for the seller who wants to avoid the risk of paying for any escalation in insurance or freight costs. Additionally, such a clause benefits the buyer who is willing to incur such costs but finds it difficult to book a ship or insurance at the port of shipment.

In selecting trade terms, the parties should also be concerned with any conflicts between the chosen trade term and other terms in the contract. For example, a CIF contract shifts the risk of loss to the buyer at the port of shipment. If the contract provides that the seller guarantees a certain weight or quality at arrival, then the risks of loss below that

weight would seem to shift back to the seller. What term will dictate liability for loss during transit? “The tendency of courts (in the United States) has been to subordinate conflicting terms to the CIF terms.”⁶ Under the UCC, a guarantee of quality clause is likely to be construed only as a guarantee of “ordinary deterioration, shrinkage, and the like in transportation.”⁷ All other causes of loss or damage remain with the buyer. Furthermore, an occurrence within the “quality clause” does not provide the buyer with a right of rejection but only a right of adjustment. Professor Berman notes that comments to UCC Section 2-321(3) make such a presumption. The exporter should quote CIF whenever possible, because it has meaning abroad. It shows the foreign buyer that the cost of shipping the product to the port in the country of importation will be borne by the seller. If assistance is needed in figuring the CIF price, an international freight forwarder can help. If at all possible, the exporter should quote the price in U.S. dollars. Doing so eliminates the risk of possible exchange rate fluctuations and the problems of currency conversion.

*[T]he express language used in an agreement is frequently a precautionary, fuller statement of the normal CIF terms and hence not intended as a departure or variation from them. Moreover, the dominant outlines of the CIF term are so well understood commercially that any variation should, whenever reasonably possible, be read as falling within those dominant outlines rather than as destroying the whole meaning of a term which essentially indicates a contract for proper shipment rather than one for delivery at destination.*⁸

Nonetheless, it is important for contracting parties not to vary recognized trade terms. The dangers of varying the standard trade terms are illustrated by *Kumar Corp. v. Nopal Lines, Ltd.*⁹ The Kumar Corporation entered into a contract to sell goods to Nava in Venezuela on a consignment basis. Consignment is the delivery of goods from an exporter (consignor) to an agent (consignee) under agreement that the agent sells the goods on the account of the exporter. The consignor retains title to the goods until sold. The consignee sells the goods for commission and remits the net proceeds to the consignor. The contract trade term was CIF. Unfortunately, the goods were stolen while in possession of the common carrier at the port of shipment. Since payment was not due until a resale of the goods in Venezuela, Nava was under no obligation to pay against documents. In bringing suit against the common carrier, Kumar would have to overcome the defense that under the CIF term, risk of loss had passed to the buyer and, therefore, Kumar had no standing to sue. Failure to overcome that defense would result in Kumar not having any recourse except for a claim under an applicable insurance policy. Ironically, Kumar’s negligence in not procuring insurance coverage enabled it to sue the common carrier. The court held that since Kumar had failed to obtain insurance as required by the CIF term, the risk of loss remained with Kumar. Thus, Kumar had the requisite standing to sue the common carrier. In international contracting, the terms as defined in INCOTERMS 2010 should be utilized. The next section will examine the most recent version of INCOTERMS, effective in 2010.

International sale of goods contracts are defined as either **shipment** or **destination contracts**. Whether a contract is described as a shipment or destination contract depends on when the risk of loss passes from the seller to the buyer. In a shipment contract, the risk of loss passes to the buyer at the point of shipment. In contrast, in a destination contract, the risk of loss passes to the buyer at the point of destination. The risk of loss refers to which party will suffer the loss of damaged or lost goods. For example, if the risk of loss has passed to the buyer and the goods are subsequently lost at sea, then the buyer will have to pay for goods it will never receive. The party that has the risk of loss is liable for any damages to the goods that occurred while it retained the risk. The trade term, among other things, allocates the risk of loss. If the contract fails to use a trade term, then generally the risk of loss passes at the time the seller delivers the goods to the carrier.¹⁰ Thus, the presumption is in favor of a shipment contract. In order to avoid risk of loss and performance disputes, the contract should use accepted trade terms to clearly state whether it is a shipment or destination contract.

It is important to examine the interrelationship between the trade term and other terms in the contract. This is especially necessary if other language in the contract can be construed as modifying the trade term. This was the issue in *Warner Bros. & Co. v. Israel*.¹¹ That case involved the purchase of Philippine sugar for shipment to New York City. The trade term in the contract stated “Philippines—CIF Terms.” Another provision in the contract provided that the seller was to deliver sugar of a “net delivered weight.” The sugar was delayed entry into the United States due to the imposition of a government sugar quota. The buyer attempted to avoid payment by arguing

that the “net delivered weight” language converted the contract to a delivery or destination contract. It argued that the net delivered weight could only be determined at the port of destination.

The court rejected the argument, holding that it was a CIF contract where the purchaser must pay upon the presentation of documents. It held that the “net delivered weight” language referred to the adjustment of the price based upon the weight of the sugar actually delivered, but was not enough to convert the express trade term into a destination contract. It further noted the general proposition that a delivery term (to be delivered to New York City) does not change an express trade term. “Under the ordinary CIF contract, delivery of the goods would not be a condition precedent to be performed at the risk of the seller. Nor is it made so merely because the obligation to contract for the carriage is expressed in the form of the delivery of the goods at a designated place.” The result may be different, however, if the destination term is included in the same provision as the trade term. It is important, therefore, to use the trade term without further explanation and to make sure that other terms in the contract do not expressly conflict with the term chosen.

The contract of carriage (bill of lading) should be consistent with the allocation of responsibilities provided by the trade term in the sales contract. A misunderstanding regarding the trade or delivery term is likely to prevent exporters from meeting contractual obligations or to make them responsible for shipping costs they sought to avoid. It is important to understand and use trade terms correctly; the trade terms in international business transactions often sound similar to those used in domestic business, but they frequently have very different meanings.¹² For this reason, the exporter must know the terms before preparing a quotation or a *pro forma* invoice.

INCOTERMS 2010

As noted above, the rules for interpreting a trade term are of primary importance in international sale of goods transactions. Trade terms are used to allocate the costs of freight and insurance, along with stating the time that the risk of loss passes to the purchaser. The rules of interpretation for trade terms also determine who is responsible for dealing with customs agents and the payment of tariffs. The INCOTERMS list of obligations that the terms allocate include: (1) obtaining necessary export licenses and government authorizations; (2) satisfying import requirements and formalities; (3) giving notice regarding a vessel hired for transport; (4) giving notice of delivery to the common carrier; (5) checking, packaging, and marking goods and obtaining transport and other documents.

The notice of the hiring of a vessel is normally the responsibility of the buyer under the FOB, FAS, and FCA terms. Notice of delivery to the common carrier is the responsibility of the seller.

Traditionally, national laws provide the rules of interpretation. In international trade, the ***INCOTERMS 2010 Manual***, published by the International Chamber of Commerce, defines trade terms. Business parties, courts, and arbitration tribunals have universally accepted INCOTERMS as the definitive source of interpreting trade terms. See Table 14.2 *Doing Business Internationally*: “INCOTERM Groups.”

INCOTERMS provides 11 terms categorized into four groups: E Group (EXW), F Group (FCA, FAS, FOB), C Group (CFR, CIF, CPT, CIP), and D Group (DAF, DDU, DDP). A key advantage in using INCOTERMS is that they have been consistently updated to reflect contemporary commercial practice. Along with selecting an INCOTERM, the parties should detail any rights and obligations associated with the shipment of the goods, including any special marking, packaging, inspection, and testing requirements. When using an INCOTERM, always cite to the ***INCOTERMS Manual***. Thus, in selecting an INCOTERM, state the three-letter trade term, such as CIF, FOB, or DES, “as defined in INCOTERMS 2010.” The 11 INCOTERMS provide a broad range of options regarding the relative responsibilities of the exporter and importer. It is important not to attempt any variation of the terms. Also, some of the

Table 14.2 *Doing Business Internationally*: INCOTERM Groups

<i>E Term</i>	<i>F Terms</i>	<i>C Terms</i>	<i>D Terms</i>
Pro-Seller (Costs, Insurance, and Risk of Loss to Buyer)	Costs to Buyer (Risk of Loss to Buyer)	Costs to Seller (Risk of Loss to Buyer)	Pro-Buyer (Costs, Insurance, and Risk of Loss to Seller)
N/A	Shipping Contract	Shipping Contract	Destination Contract

terms are to be used only for certain modes of transportation, while others can be used for all modes of transportation. The FAS, FOB, CFR, and CIF terms are used for carriage of goods by sea. The EXW, FCA, CIP, CPT, DAF, DDU, and DDP terms can be used generally, including for multimodal means of shipment.

INCOTERMS 2010 made a number of changes, including: (1) eliminating the ocean carriage trade terms DES and DEQ; (2) placing the export clearance obligation under FAS on the seller (previously on the buyer); (3) specifying the seller's obligation to load the goods on the buyer's collecting vehicle and the buyer's obligation to receive the seller's arriving vehicle unloaded under FCA; and (4) suggesting that instead of relying on the "crossing the ship's rail" standard found in the FOB, CFR, and CIF terms, the parties are invited to choose such terms as FCA, CPT, and CIP where delivery of the goods is connected to the handing over of the goods to the carrier.

The "crossing the ship's rail" standard shifts the risk of loss to the buyer when the cargo passes an imaginary line above the ship's rail. This murky standard is likely to produce dispute in the event that the goods are damaged while in possession of the carrier prior to loading or while the goods are being loaded on the ship. The next few sections will examine the more important INCOTERMS in greater detail. See Figure 14.9 *Focus on Transactions*: "Summary of INCOTERMS 2010."

Ex Works Term

The **ex works** term is the most pro-seller trade term. It means that the seller fulfills his obligation to deliver when he notifies the buyer that the goods are available at his factory, warehouse, or office. The seller is not responsible for loading the goods on the vehicles provided by the buyer or for clearing the goods for export. The buyer bears all the costs and risks of transport from seller's place of business to the point of destination. Only an expert importer willing to undertake satisfying export formalities in a foreign country should use this term.

FOB and FAS Terms

Under FOB (free on board), the seller must deliver conforming goods on board the vessel named by the buyer at the stipulated time and must give notice to the buyer of the delivery. The seller bears all costs up to the passing of the ship's rail at the port of shipment, including exportation fees, the packing and checking of the goods, and the costs of obtaining a document evidencing the loading of the goods. He is also obligated to obtain a certificate of origin at the buyer's request and expense.

In turn, the buyer must book the carriage and give notice to the seller of the name, loading berth, and dates for delivery to vessel. The buyer, along with bearing the costs of freight and insurance, pays the costs of obtaining most documents including the certificate of origin, consular invoice, and in some incidences the bill of lading. It should be noted that it is a common practice in the United States to use the FOB term in conjunction with the place of destination, such as "FOB Buffalo (place of destination)." This would, in essence, convert the contract into a destination contract whereby the risk of loss would not pass until arrival in Buffalo. In order to prevent this change, the place of destination should be placed in a separate clause independent of the FOB term.

FAS or free alongside ship is essentially the same as FOB except that the seller's responsibilities end when the goods are brought alongside the ship. This is performed when the goods are delivered on the dock or placed in lighters at the port of shipment. The buyer has to bear all costs and risks of loss, including the loading of the goods onto the ship, at the moment the goods are placed alongside the ship. The responsibility of obtaining export clearance is also placed upon the buyer. Therefore, this term should not be used by an unsophisticated buyer who is not familiar with the formalities of exporting.

CIF and CFR Terms

Under the CIF term, the seller's responsibilities include obtaining a marine insurance policy and a carriage contract. He must also at his expense obtain any export license and arrange for the loading of the goods. The marine insurance policy shall be in the amount of CIF value plus 10 percent. The seller must also obtain war risk coverage

Ex Works (named place)

Ex works, sometimes referred to as *ex factory*, means that the seller fulfills his obligation to deliver when he has made the goods available at his premises (works, factory, warehouse) to the buyer. He is not responsible for loading the goods on the vehicle provided by the buyer or for clearing the goods for export, unless otherwise agreed. The buyer bears all costs and risks involved in taking the goods from the seller's premises to the desired destination. This term thus represents the minimum obligation for the seller. The risk of loss may shift to the buyer before he actually picks up the goods such as when the seller notifies the buyer that the goods are ready for pick-up).

FCA Free Carrier (named place)

Free carrier means that the seller fulfills his obligation to deliver when he has handed over the goods, cleared for export, into the charge of the carrier named by the buyer. When, according to commercial practice, the seller's assistance is required in making the contract with the carrier (such as in rail or air transport) the seller may act at the buyer's risk and expense. This term may be used for any mode of transport, including multimodal transport. If the buyer instructs the seller to deliver the cargo to a person, for example, a freight forwarder who is not a carrier, the seller is deemed to have fulfilled his obligation upon delivery to that person.

FAS Free Alongside Ship (named port of shipment)

Free alongside ship means that the seller fulfills his obligation to deliver when the goods have been placed alongside the vessel on the quay or in lighters at the named port of shipment. This means that the buyer has to bear all costs and risks of loss of or damage to the goods from that moment. The FAS term requires the buyer to clear the goods for export. This term can only be used for sea or inland waterway transport.

FOB Free on Board (named port of shipment)

Free on board means that the seller fulfills his obligation to deliver when the goods have passed over the ship's rail at the named port of shipment. The FOB term requires the seller to clear the goods for export. This term can be used only for sea or inland waterway transport.

CFR Cost and Freight (named port of destination)

Cost and freight term is also referred to as the C & R term (American UCC). Cost and freight means that the seller must pay the costs and freight necessary to bring the goods to the named port of destination but the risk of loss of or damage to the goods, as well as any additional costs due to events occurring after the time the goods have been delivered on board the vessel, is transferred from the seller to the buyer when the goods pass the ship's rail in the port of shipment. This term can be used only for sea and inland waterway transport.

CIF Cost, Insurance, and Freight (named port of destination)

Cost, insurance, and freight means that the seller has the same obligations as under CFR but with the addition that he has to

procure marine insurance against the buyer's risk of loss of or damage to the goods during the carriage. The seller contracts for insurance and pays the insurance premium. The buyer should note that under the CIF term the seller is required to obtain insurance only on minimum coverage. This term can be used only for sea and inland waterway transport.

CPT Carriage Paid To (named place of destination)

Carriage paid to means that the seller pays the freight for the carriage of the goods to the named destination. The risk of loss of or damage to the goods, as well as any additional costs due to events occurring after the time the goods have been delivered to the carrier, is transferred from the seller to the buyer when the goods have been delivered into the custody of the carrier. If subsequent carriers are used for the carriage to the agreed destination, the risk passes when the goods have been delivered to the first carrier. This term may be used for any mode of transport including multimodal transport.

CIP Carriage and Insurance Paid To (named place of destination)

Carriage and insurance paid to means that the seller has the same obligations as under CPT but with the addition that the seller has to procure cargo insurance against the buyer's risk of loss of or damage to the goods during the carriage. This term may be used for any mode of transport including multimodal transport.

DAF Delivered at Frontier (named place)

Delivered at frontier means that the seller fulfills his obligation to deliver when the goods have been made available, cleared for export, at the named point and place at the frontier, but before the customs border of the adjoining country. The term frontier may be used for any frontier including that of the country of export. Therefore, it is of vital importance that the frontier in question be defined precisely by always naming the point and place in the term. The term is used primarily when goods are to be carried by rail or road, but it may be used for any mode of transport.

DDU Delivered Duty Unpaid (named place of destination)

Under delivered duty unpaid, the seller fulfills his obligation when the goods are made available at the named place in the country of importation. The seller has to bear the costs and risks involved in bringing the goods to the country of importation. The buyer is responsible to pay duties, taxes, and other official charges payable upon importation as well as the costs and risks of carrying out customs formalities.

DDP Delivered Duty Paid (named place of destination)

Delivered duty paid means that the seller fulfills his obligation to deliver when the goods have been made available at the named place in the country of importation. The seller has to bear the risks and costs, including duties, taxes, and other charges of delivering the goods and cleared for importation. Whilst the *ex works* term represents the minimum obligation for the seller, DDP represents the maximum obligation. This term may be used irrespective of the mode of transport.

Figure 14.9 *Focus on Transactions*: Summary of INCOTERMS 2010.

at the request and expense of the buyer. He must obtain a “clean, on-board bill of lading.” It should be noted that some clauses commonly inserted into the bill of lading that refer to the condition of the packaging do not render the bill of lading “unclean.” For example, clauses that note that the packages are “used” or “secondhand” are considered descriptive and not a notation of perceived damage or nonconformity.

The costs of packing and checking the goods are those of the seller. In turn, the buyer is required to pay the cost of unloading, along with lighterage and wharfage charges. The buyer can transfer the costs of unloading by negotiating a “CIF landed” term. The buyer also pays for the costs of obtaining the certificate of origin and any necessary import licenses or permits, along with all customs duties. The party responsible for customs clearance or delivery should negotiate a *force majeure* or **time-extension clause** in case of delay in clearing customs or making delivery. The CFR term is essentially the same as the CIF term except that the responsibility to obtain and pay for the marine insurance is shifted to the buyer. It is important to understand that the “C terms” are “shipment contracts” and not “arrival or destination contracts.” The risk of loss is transferred, like in the “F terms,” at the port of shipment.

CPT, CIP, and FCA Terms

The traditional prevalence of the FOB, CFR, and CIF terms is likely to give way to increased use of the CPT, CIP, and FCA terms. The traditional supremacy of FOB, CFR, and CIF contracts was due to the central importance of marine carriage. The advent of modern containerization and multimodal transport is likely to result in these terms yielding to the FCA, CPT, and CIP terms, simply because the traditional function of the ship’s rail as the dividing point between sellers’ and buyers’ functions has been replaced by other points, such as cargo terminals or other reception facilities. This has also influenced documentation and reduced significantly the use of on-board bills of lading. Thus, even in the carriage of goods by sea, nonnegotiable sea waybills have replaced bills of lading. Under INCOTERMS 2010, the FCA term now provides that delivery by seller is completed only when the goods have been loaded on the transport provided by the carrier.

D Terms

As noted earlier, INCOTERMS 2010 eliminated the traditional ocean carriage destination terms: DES and DEQ. DES term obligated the seller to bear the costs and risks of shipment to the port of destination. Seller’s responsibilities ended when the goods were made available to the buyer on board the ship at the port of destination. The DEQ term gave the seller the added responsibility of unloading the goods and making the goods available to the buyer at the wharf (quay). It also meant that it was the seller’s responsibility to clear the goods through customs.

The D group is now made up of three multimodal terms—DAF, DDU, and DDP—which can be used for any type of transport, including ocean carriage. These are destination terms, meaning that the risk of loss does not pass to the buyer until some point after the shipment of the goods. The DAF or delivered at frontier requires the seller to clear the goods for export and deliver the goods to the border of an adjoining country. This term is used primarily in conjunction with rail or road transport, but may also be used for ocean carriage. The frontier needs to be expressly defined because it can mean either the border of the country of import or export. The **DDU** term stands for delivered duty unpaid, while the DDP term stands for delivered duty paid.

While *ex works* signifies the seller’s minimum obligation, DDP, when followed by words naming the buyer’s place of business, denotes the seller’s maximum obligation. The seller must clear the goods for import into the buyer’s country. A DDU contract is a destination contract in which the buyer is responsible for clearing the goods through customs. The DDP term places the costs and risks of importation clearance on the seller.

Both the DDP and DDU terms may be modified in the event the buyer and seller want to allocate specific costs associated with the importation. If the parties agree that the buyer will pay all the import costs and fees except for any value-added tax, then they could modify the DDU term to read *Delivered Duty Unpaid, VAT Paid*. The parties

may instead want the seller to pay for all import costs except for any value-added taxes. In this regard, they could modify the DDP term to read *Delivered Duty Paid, VAT Unpaid*.

Outsourcing and the CIF Term

Companies that outsource to obtain materials or component parts commonly use the CIF term. It allows a company to obtain bids from companies throughout the world since the price in all the bids would be for deliver at the same port in the buyer's home country. If instead the buyer receives bids based on a FOB contract, it may be difficult to determine which bid is the best one. For example, a company from Buffalo, New York, receives bids of \$38 per unit from a company in Montreal, Canada; \$34 per unit from a company in São Paulo, Brazil; and \$30.50 from a company in Sabah, Malaysia. It would seem that the lowest bid is from the Malaysian company, but the buyer would have to pay for the costs of freight, insurance, and import tariffs. When those costs are factored in, the cheapest price could easily be the bid from the Montreal company since transport of the goods from Montreal to Buffalo is much shorter distance and substantially less costly, likely accomplished by trucking transport, and since Canada is a NAFTA country (see Chapter 7 on "Free Trade Agreements"), the tariff rate should be less than the rates charged for imports from Brazil and Malaysia.

Multimodal Transport

The "F" and "D" terms apply to any mode of transport (ocean, railroad, trucking) or multimodal transport, where the bill of lading (multimodal bill of lading) covers more than one type of transport. The old ocean transport terms DES and DEQ were eliminated is due to the popularity of multimodal transport. The multimodal terms DDU and DDP can be used to make the same risk and cost allocations as did the old DES and DEQ terms. Before the establishment of multimodal carriers and the multimodal bill of lading, title documents (bills of lading) would have to be procured for each segment of the transport. In addition, the different types of common carriers—truck, railroad, ships—are governed by different laws and each type issues bills of lading. In case of damage or loss, it would have to be determined in which segment of the transport the damage or loss occurred in order to determine the applicable law and the culpable party.

For example, a company in Lexington, Kentucky contracts to sell its goods to a company in Dusseldorf, Germany. The chain of transport would involve a series of common carriers: the seller loads the goods into a shipment container that is then handed over to a trucking company for delivery of the goods to a railroad company in Louisville, Kentucky, for transport to the Port of New Orleans and loaded onto a ship. The ship transports the goods to the Port of Rotterdam in Germany where they are transported by a railroad to Dusseldorf. In this scenario, there are four common carriers and could have involved a fifth, such as a trucking company in Germany. In a CIF contract, the seller would first obtain a bill of lading from the trucking company, then one from the railroad, and finally an "on-board" bill of lading from the shipping contract. In a DPP (delivery duty paid), with delivery to Dusseldorf, the seller would also have to obtain a bill of lading from the German railroad company. Instead, the shipper (seller or buyer) may hire a multimodal transport company that will arrange the entire transport and issue a single multimodal bill of lading.

The FCA (free carrier) term requires the seller to deliver the goods to the first common carrier or the common carrier designated by the buyer. In the above scenario, either the trucking or railroad company (assuming the trucking company was hired by the buyer) could be considered the first common carrier. Under FCA, the seller must still clear the goods for export.

Standards, Certifications, and Markings

One of the continuing barriers to international trade are differing country products standards. Product standards may concern health, safety, quality, and environmental issues relating to a product. A product may meet the standards in some countries and be insufficient for importation to other countries. Fortunately, there has been a

SAMPLE EU SAD (SINGLE ADMINISTRATIVE DOCUMENT)

THIS SET OF FORMS IS PRINTED ON NCR PAPER. IF COMPLETING BY HAND, WRITE IN BLOCK LETTERS, USING A BALLPOINT PEN AND APPLY MAXIMUM PRESSURE WITH THE SET RESTING ON A FIRM SURFACE.

HANDLE WITH CARE

A OFFICE OF DISPATCH/EXPORT

EUROPEAN COMMUNITY		1 2 3 4 5 6 7									
Copy for the country of dispatch/export	1	<div style="display: flex; justify-content: space-between;"> <div>2 Consignor/Exporter</div> <div>No</div> </div>									
			1 DECLARATION								
			3 Forms		4 Loading lists						
			5 Items		6 Total packages		7 Reference number				
			9 Person responsible for financial settlement: No								
			10 Country first destination		11 Trading country		13 CAP				
			14 Declarant/Representative		No		15 Country of dispatch/export		15 C disp./exp. Code		
			16 Country of origin		17 Country of destination						
			18 Identity and nationality of means of transport at departure		19 Ctr.		20 Delivery terms				
			21 Identity and nationality of active means of transport crossing the border		22 Currency and total amount invoiced		23 Exchange rate		24 Nature of transaction		
25 Mode of transport at the border			26 Inland mode of transport		27 Place of loading		28 Financial and banking data				
		29 Office of exit		30 Location of goods							
		31 Packages and description of goods		32 Item No		33 Commodity Code					
		34 Country origin Code		35 Gross mass (kg)							
		37 PROCEDURE		38 Net mass (kg)		39 Quota					
		40 Summary declaration/Previous document									
		41 Supplementary units									
		42 Statistical value									
		43 Identification of warehouse									
		47 Calculation of taxes		48 Deferred payment		49 Identification of warehouse					
		Type		Tax base		Rate		Amount		LMP	
		Total:									
		50 Principal		No		Signature					
		51 Intended offices of transit (and country)		represented by		Place and date:					
		52 Guarantee not valid for		Code		53 Office of destination (and country)					
		D CONTROL BY OFFICE OF DEPARTURE		Stamp:		54 Place and date:					
		Result:		Seals affixed: Number:		Identity:		Time limit (date):		Signature:	
		Signature and name of declarant/representative:		Signature and name of declarant/representative:		Signature and name of declarant/representative:					
		Signature and name of declarant/representative:		Signature and name of declarant/representative:		Signature and name of declarant/representative:					

C88 (1-8)

PCU/January 1996

Figure 14.10 Comparative Law: Single Administrative Document.

movement toward the harmonization of standards at the supranational level. A producer of goods can obtain recognized certifications that will facilitate importation into other countries. Markings are often required on the products to confirm standards certifications.

EU Standards and CE Marking

Importing to the countries of the European Union (EU) has been simplified by the creation of a uniform import known as the EU Single Administrative Document (SAD). See Figure 14.10 *Comparative Law*: “Single Administrative Document.” This form can be used for entering goods into any of the 28 countries of the EU. Once imported into one of the countries, the goods may be freely shipped throughout the EU (see Chapter 8, “European Union”).

Prior to exporting, U.S. manufacturers have to consider product certifications for the EU market. Certifications relate to conformity (testing and certification) to EU regulatory requirements. For the majority of exported products, compliance is visibly attested to by the placement on the product of CE marking.

Since EU legislation harmonizes mandatory requirements for product safety throughout the EU, a manufacturer only needs to go through the process once and can then export to all 28 EU member states. With appropriate certification, goods travel freely within the borders of the Single Market.

The **CE mark** (for the French *Conformité Européenne*) certifies that a product has met EU health, safety, and environmental requirements, which ensure consumer safety. Manufacturers in the EU and abroad must meet CE marking requirements where applicable in order to market their products in Europe. The following countries require CE marking: the countries of the **European Economic Area** or EEA (28 EU countries plus Iceland, Liechtenstein, and Norway). The countries of the EEA are shown in Figure 14.11 “Countries of the European Economic Area.” Switzerland and Turkey also require CE Marking.

Thus, CE marking provides product access to 33 European countries (including Turkey) with a population of nearly 600 million. As of January 1, 2015, Eurostat reported the EU population at 508 million. In addition, Switzerland has a population of about 8 million; Turkey at 76 million; Norway at 5 million; Iceland at 340,000; and Liechtenstein at 38,000. Unfortunately, there is no comprehensive list of the products that require a CE mark. Therefore, it is the manufacturer’s responsibility to determine if a product requires a CE marking. In order to determine if your product needs a CE marking, you would have to review the EU Directives (see Chapter 8) that relate to your product. Fortunately, Export.gov provides an extensive CE Marking Guide (see Figure 14.12 *Doing Business Internationally*: “CE Marking Step-by-Step”).

Notified Bodies (see Figure 14.12) certify that a product meets all the applicable EU requirements. The conformity assessment procedure is carried out before the product can be sold and includes the manufacturer providing a **Declaration of Conformity**. An example is provided in Figure 14.13 *Doing Business Internationally*: “Declaration of Conformity.”

Inspection Certificates

Inspection certificates satisfy other import standards and information requirements. The type of certificate will vary depending on the type of the good: Certificate of Inspection (verifying the amount and description of the goods), Phytosanitary Certificate (plant products), Veterinary Certificate, Safety Test Certificate (toys, automobiles, electrical products, and so forth), Quality Certificate (all sorts of products), Dangerous Goods Certificate, and Sterilization Certificate (packaging materials).



Image 14.1 CE Marking.

Austria	Latvia
Belgium	Liechtenstein
Bulgaria	Lithuania
Croatia	Luxembourg
Cyprus	Malta
Czech Republic	Netherlands
Denmark	Norway
Estonia	Poland
Finland	Portugal
France	Romania
Germany	Slovakia
Greece	Slovenia
Hungary	Spain
Iceland	Sweden
Ireland	United Kingdom
Italy	

Figure 14.11 Countries of the European Economic Area.

<ul style="list-style-type: none"> Find the applicable Directive. For example, an overview of the Electromagnetic Compatibility (EMC) Directive (2004/108/EC) gives U.S. manufacturers an understanding of the main features of the Directive and guides them through the process of certifying for the CE mark requirements. It also provides a list of labs around the country that can do CE marking. Determine the essential requirements in the Directive. Review the Harmonized European standards produced by the three European Standardization Organizations—European Standardization Organizations (CEN), European Committee for Electrotechnical Standardization (CENELEC), and the 	<p>European Telecommunications Standards Institute (ETSI). The letters “CE” on a machine are the European supplier’s claim that the machine meets the essential requirements (ESHRs) of all relevant European Directives.</p> <ul style="list-style-type: none"> Locate Notified Bodies (accredited test laboratories). European countries designate companies certified to perform CE compliance. The EEA also has Mutual Recognition Agreements (MRAs), which are bilateral agreements that recognize testing and certifications from other countries. The EEA has MRAs with Australia, Canada, Israel, Japan, New Zealand, Switzerland, and the United States.
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Figure 14.12 Doing Business Internationally: CE Marking Step-by-Step.

<p>Manufacturer: XYZ Corp. 325 Grassy Knoll Garden City, New York Telephone No. (516) 555-3333</p> <p>Product: Walk-Behind Lawn Mower (3.5 HP) Model No. 3.5L Serial Number 350000-360000</p> <p>The undersigned hereby declares, on behalf of the XYZ Corp. of Garden City, New York, that the above-referenced product, to which this declaration relates, is in conformity with the provisions of:</p> <p>Council Directive 2006/42/EC (May 17, 2006) on the Approximation of the Laws of the Member States Relating to Machinery; Council Directive 2004/108/EC (December 15, 2004) on Electromagnetic Compatibility;</p>	<p>List European standards used Council Directive 2006/95/EC (December 12, 2006) on Low Voltage Equipment Safety; List European standards used Council Directive 2000/14/EEC amended by Directive 2005/88/EC (June 17, 2006) about noise limits and labelling requirements machines intended for use outdoors.</p> <p>The Technical Construction File required by this Directive is maintained at the corporate headquarters of XYZ, Inc., 325 Grassy Knoll, Garden City, New York.</p> <p>Joseph P. Glass Vice President–Design Engineering</p>
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Figure 14.13 Doing Business Internationally: Declaration of Conformity.

Phytosanitary Inspection Certificate: A certificate issued by the government of the country of export that certifies that the goods being exported have been inspected and are free of harmful pests or plant diseases.

The types and numbers of certificates required vary depending on the product and the country of import. Table 14.3 *Doing Business Internationally*: “Certifications for Import” lists some of the certificates required by certain countries.

Labeling and Marking Requirements

The overseas buyer usually specifies which export marks should appear on the cargo. Products may require many markings for shipment. For example, exporters need to put the following markings on cartons to be shipped: shipper’s mark; country of origin; weight marking (in pounds and kilograms); number of packages and size of cases (in inches and centimeters); handling marks (international pictorial symbols); cautionary markings, such as “this side up” or “use no hooks” (in English and in the language of the destination country); port of entry; labels for hazardous materials (universal symbols adopted by the International Air Transport Association and the International Maritime Organization); and ingredients (language of the destination country).

Table 14.3 Doing Business Internationally: Certifications for Import

<i>Certificate</i>	<i>Description</i>	<i>Countries</i>
Analysis	Required for food, drugs, cosmetics, and toxic products	Nigeria, Chile (foodstuffs only)
Composition	Used food and clothing	Greece
Disinfection	Used coffee sacks; shaving brushes; goods and clothing	Colombia (sacks), Egypt (shaving brushes), Greece (clothing)
Free Sale	Goods are freely sold in country of origin	Argentina, Mexico, Nigeria, Saudi Arabia
Halal	Certified by an Islamic center	Saudi Arabia, United Arab Emirates
Health	Meat products	Hong Kong, India, Indonesia (fruits, potatoes, and seeds), Israel, Japan (textiles and wool), Malaysia, Netherlands, Norway (pickled meat), Pakistan (no pig, swine, boar content)
Kosher	Food products	Israel
Microbiological	Products that contain microorganisms	Mexico
NAFTA Origin	NAFTA country to NAFTA country	Canada, Mexico, U.S.
Pharmaceutical	Registered with National Hungarian Institute for Pharmacy	Hungary
Pro-Vitamin A	Verify level of Vitamin A in foods for animal use	Brazil
Purity	Flour, butter, milk	Peru
Radiation	Agricultural products	Egypt
Textile and Footwear Origin Certificate	Certifies the origin of this particular products	Mexico
Whiskey Certificate	Periodically whiskey products may be banned	Malaysia
Wine	Certifies type of wine and country of origin	Austria, Belgium, Finland, France, Germany
Wood Products Certificate	Certifies that wood products have been treated or fumigated	New Zealand, China (wood packaging only), United Kingdom

Chapter Summary

- 1 A number of methods of exporting and importing carry a high risk to one or both of the contracting parties. These include open account, cash in advance, and consignment sales.
- 2 The exporter often prepares a *pro forma* invoice or price quotation to calculate its selling price. It is vital that this price incorporates all the additional expenses related to the international sale of goods.
- 3 Much of the risks of exporting–importing—seller’s risk of nonpayment and buyer’s risk of nondelivery—are mitigated by the documentary collections transaction. Documentary collections change the sale of goods transaction into a sale of documents. The bill of lading is the key title document that allows for this to happen. The bill of lading is obtained by the exporter and is packaged with other required documents. The documents are then transmitted using commercial banks to the importer in exchange for payment (while the goods are in transit).
- 4 The standard bill of lading is either an ocean bill of lading or a multimodal bill of lading. The common ocean bill of lading will be negotiable, on-board, and clean. The buyer should demand delivery of a full set (all copies) of the bill of lading.
- 5 A bank draft (bill of exchange) is one of the key documents since it is the means by which the banks process the payment to the exporter. A collections transaction that requires immediate payment on the delivery of the documents is referred to as a Cash Against Documents transaction, which requires the use of a sight draft. If payment is not to be made until after the documents are presented and accepted by the importer, a time draft is required. This type of transaction is referred to as a Documents Against Acceptance transaction. The difference between a documentary draft and a regular check is that the exporter is both the drawer and beneficiary of the draft.
- 6 In negotiating a sales contract, the buyer (importer) will require that the exporter prepare and obtain numerous documents. Some of the more common documents include: bill of lading, bank draft, commercial invoice, export license, inspection certificate, insurance binder, certificate of origin, and packing list.
- 7 One of the most important terms in international sales contracts is the trade term. Trade terms allocate the costs of freight, insurance, and risk of loss between the exporter and the importer, along with many other responsibilities, such as obtaining an export license, loading the goods for transport, import clearance and the payment of tariffs, and the unloading of the goods. There are 11 internationally recognized trade terms called INCOTERMS, which are published by the International Chamber of Commerce.
- 8 INCOTERMS 2010 are divided into four groups: ex factory (ex-works), F, C, and D. The ex factory is the most pro-seller term, while the DDP (Delivered Duty Paid) is the most pro-buyer term. F and C terms are shipment contracts. F terms allocate the costs and insurance of transport to the buyer, and the risk of loss transfers at the time of shipment. C terms allocate the costs of freight, and sometimes the cost of insurance, to the seller, but the risk of loss passes at the time of shipment. Under the D terms, the seller is allocated the costs of freight, insurance, and the risk of loss to the point or port of destination. The CIF term is often used by importers who are obtaining bids from companies in different places of the world (outsourcing).
- 9 Other requirements that exporters of goods to foreign countries need to be aware of are product standards, certifications, and markings mandated by that country.

Key Terms

Air Waybill	CE Mark	Consignment Sale
Anti-Diversion Clause	Certificate of Inspection	Consular Invoice
Bank Draft	Certificate of Origin	Cost, Insurance, and Freight (CIF)
Bill of Exchange	Clean Bill of Lading	Cost-plus Method
Bill of Lading	Commercial Invoice	Declaration of Conformity
Cash Against Document	Confirmed Letter of Credit	Delivered Duty Unpaid (DDU)
Cash in Advance	Consignee	Destination Contract

Destination Control Statement	INCOTERMS 2010	Received-for-Shipment Bill of Lading
Documentary Collections Transaction	Insurance Certificate	Risk of loss
Documentary Credit Transaction	Marginal Cost Pricing	Risk-shifting clause
Documents Against Acceptance	Mutual Recognition Agreements	Shipment contract
Draft	Notified Bodies	Shipper's Export Declaration (SED)
Drawee	On-board Bill of Lading	Sight Draft
Drawer	Open Account	Straight Bill of Lading
Electronic Bill of Lading	Order Bill of Lading	Time Draft
European Economic Area	Packing Slip	Time-Extension Clause
Ex Works	Payment Against Acceptance	Trade Term
Export License	Payment Against Documents	
Free on Board (FOB)	Phytosanitary certificate	
	<i>Pro Forma</i> Invoice	

Chapter Problems

- 1 A buyer and seller entered into a contract for the sale of widgets, "CIF Omaha." A further provision stated that delivery was to be at a "factory in Omaha, Tulsa, or Kansas City, to be designated by the buyer." The widgets were lost in transit. The buyer refused to pay on the presentation of the documents, arguing that the additional provision had converted the shipment contract to a destination contract. What type of contract was this and why? What advice would you give someone regarding the use of trade terms?
- 2 You are the purchasing agent for a U.S. luggage manufacturer. You are asked to outsource some of the components, including steel strips used in the fabrication of the structural frames of the larger pieces of luggage. Your company's manufacturing plant is located in Peoria, Illinois. Your research finds that the companies best able to supply the strips are located in Windsor, Canada; São Paulo, Brazil; and Padang, Indonesia. In asking for price quotations, what types of documents should you require? From your perspective, which trade term should be used in the price quotations?
- 3 You are a manufacturer of precision industrial tools and parts based in Ithaca, New York. You have been contacted by a manufacturer in Budapest, Hungary, to begin supplying it with an assortment of your products. Using INCOTERMS, prepare a *pro forma* invoice with three different shipping options. For each option (INCOTERM) itemize the costs and relative responsibilities of the two parties. Consider how you will get the goods from Ithaca to Budapest. What modes of transport will need to be utilized? Who can you contact for information needed to prepare the invoice?
- 4 An export contract required that the seller provide: "a full set of three original clean on board bills of lading." Instead, the seller presented a full set of three clean on-board bills of lading but only one was marked "Original." The other two bills of lading were marked "Duplicate" and "Triplicate." Can the buyer reject the bills of lading as not conforming to the documentary requirements of the contract?
- 5 A foreign buyer negotiates with a foreign exporter for goods to be shipped out of a foreign port. To protect itself from fraud in the transaction, the buyer requires that the exporter provide an inspection certificate as one of the documents to be presented for payment. When the documents were presented for payment, the buyer noticed that the date on the inspection certificate was later than the shipment date on the bill of lading. The certificate failed to state when the inspection occurred. Can the buyer refuse payment due to this discrepancy?
- 6 What is the legal status of INCOTERMS? Is it a law?
- 7 What are the main differences between the FOB, CIF, and DDP INCOTERMS?
- 8 What INCOTERMS are only used for ocean transport?
- 9 What right of inspection does a buyer have under the CIF INCOTERMS?

- | | | |
|------------------------------------------------|-----|-------|
| 10 Write out the words for the INCOTERMS acro- | CFR | _____ |
| noms: | CIP | _____ |
| EXW | CPT | _____ |
| FCA | DAP | _____ |
| FOB | DAT | _____ |
| FAS | DDP | _____ |
| CIF | | _____ |

Internet Exercises

- 1 You are unsure of what trade term to use in negotiating an export contract. You are willing to be responsible for the loading and shipping costs to the port of destination, along with the cost of unloading, but do not want to be responsible for import and customs clearance. What INCOTERM would best serve your needs? See http://export.gov/faq/eg_main_023922.asp.
- 2 Select a country and research the documentary requirements for the importation of goods into that country. Such information can be obtained from the following sources: (1) U.S. Department of Commerce, (2) foreign government web sites, especially consulate sites, (3) *Bureau of National Affairs Export Shipping Manual*, and (4) National Council on International Trade Documentation (NCITD).
- 3 Check the services and types of e-documents provided through the Bolero Project at www.bolero.net.

Notes

- 1 *The Delfini*, 1 *Lloyd's Law Report* 252, 268 (1990).
- 2 2000 U.S. App. LEXIS 11573 (9th Cir. 2000).
- 3 Uniform Customs and Practices for Documentary Credits as published by the International Chamber of Commerce (UCP). See Chapter 15.
- 4 "Where the contract contemplates overseas shipment and contains a term CIF or C & F or FOB vessel, the seller unless otherwise agreed must obtain a negotiable bill of lading stating that the goods have been loaded on board or, in the case of a term CIF or C & F, received for shipment." UCC § 2-323(1).
- 5 Examples of risk-shifting clauses include arbitration, forum selection, choice of law, *force majeure*, and liquidated damages clauses.
- 6 Berman at 250–251. Professor Berman notes a more drastic example of inconsistency when a CIF term is coupled with a "no arrival, no sale" clause. "With full risk of loss on the seller, it makes no sense for the buyer to have the right to the insurance proceeds."
- 7 UCC § 2-321(2).
- 8 UCC § 2-320, Comment 14.
- 9 462 So.2d 1178 (Fl. Ct. Appeals 1985).
- 10 See CISG Article 67 ("handing the goods over to the first carrier") when the contract envisions carriage of goods and Article 69 (when contract requires buyer to pick up goods at seller's place of business).
- 11 101 F.2d 59 (2d Cir. 1939).
- 12 For example, compare INCOTERMS with Sections 2-319 ("FOB and FAS"), 2-320 and 2-321 ("CIF and C & F"), and 2-322 ("Delivery Ex Ship") of the Uniform Commercial Code.

INTERNATIONAL TRADE FINANCE

The letter of credit is the main topic of this chapter. The risk of nonpayment is removed through the use of a **documentary credit transaction**. In such a transaction, the buyer obtains from a bank a letter of credit that guarantees payment to the seller. Substituting the credit or guarantee of a bank for that of the buyer eliminates the risk of nonpayment. This chapter will examine three uses of letters of credit in international sales transactions. First, the letter of credit is used as a device to guarantee buyer's payment obligation to the seller in a documentary transaction. Second, the letter of credit is used as a *standby* to guarantee a performance obligation. Third, the letter of credit is used to help finance the exporting or importing of goods.

As discussed in Chapter 14, in order to lower the risks of nondelivery or nonpayment, the parties often agree to require payment against collection of documents. In the **documentary collections transaction**, the seller does not give up control of the goods until the buyer purchases the documents, minimizing the seller's risk of nonpayment. At the same time, the buyer's nondelivery risk is minimized because, with the documents, it obtains legal control over the goods in transit. The buyer's only remaining risk is fraud, where the documents do not reflect the true shipment. Requiring preshipment inspections minimizes this risk. One risk for the seller remains—the risk that the buyer will dishonor its obligation to purchase the documents. In that case, the seller retains control over the goods, but the goods are in transit to a distant port. The cost of returning or transshipping the goods or finding an alternative buyer is likely to be substantial. In order to avoid this risk, the seller often requires the buyer to obtain a letter of credit guaranteeing payment whether or not the buyer actually accepts the delivery of the documents.

Documentary Letter of Credit

Letters of credit have been called the lifeblood of commerce. The origins of the letter of credit in international transactions may be traced to the bankers in Renaissance Europe, Imperial Rome, ancient Greece, Phoenicia, and early Egypt. These simple instruments have survived because of their inherent reliability, convenience, economy, and flexibility. In initial transactions with a new or unknown business party, securing payment is a crucial concern. A letter of credit adds a bank's promise to that of the foreign buyer of paying the exporter when the exporter has complied with all the terms and conditions of the letter of credit. For a list of the terminology relating to documentary credits and their use in trade finance, see Figure 15.1 *Focus on Transactions*: "Definitions of Key Letter of Credit and Finance Terms."

The method of payment and the requirement that the buyer provide a letter of credit to guarantee payment in an international sale of goods is, of course, a matter for the parties to negotiate. Equally important is for the contract to clearly state the parties' intention as to the type of letter of credit to be provided. The following is a checklist that shows the characteristics of the letter of credit that should be stated in the contract:

Irrevocable Documentary Credit

Confirmed _____ Unconfirmed _____

Place of issue (if applicable): _____ Place of confirmation: _____

Credit available:

Partial shipments: ____ Transshipment: ____

____ By payment at sight

____ By acceptance of draft at ____ days

Date on which the documentary credit must be notified to seller ____ days before date of delivery

The letter of credit need not state that it is irrevocable by the bank since revocable credits are rare and if the letter fails to specify the type, then it will be presumed to be irrevocable. Although it is good practice to expressly state that the letter of credit is to be irrevocable. Notice that the title states “documentary credit” instead of letter of credit. This phrase is used because the letter of credit in exporting–importing is heavily dependent on the presentation of documents provided by the seller.

It is very important that the credit be designated as confirmed or unconfirmed. The next two lines in the above checklist deal with this issue. The sophisticated seller–exporter will require a confirmed letter of credit, which requires that payment be guaranteed by the issuing bank (buyer’s bank) and a bank located near the seller (seller’s bank). The second bank is called the confirming bank since it is co-guarantying payment along with the issuing bank. This may allow the seller to obtain payment sooner upon delivery of documents to the confirming bank and will allow the seller to bring a claim against the local bank in the event the credit is not honored. The credit may also allow for partial payments upon partial shipments or at the time of transshipment. In the latter situation, the buyer may request a transshipment of the goods to a different port of destination, giving the seller the right to request a partial or full payment.

The next two entries—by payment and by acceptance—relate to the time when payment must be made. In the first case, the documents are delivered to the issuing bank (at sight) and the documents are given to the buyer upon payment. The second option is used when the seller agrees to give the buyer additional time for payment. In this case, a number is placed in the blank before the word “days”; the buyer is then required to make payment within that number of days after receiving the documents. Note, however, that the buyer has to “accept” the bank draft at sight before receiving the documents. This acceptance creates an independent obligation (negotiable instrument) to pay so that if the buyer later finds the documents to be nonconforming, it still must honor its independent obligation to pay the draft within the time provided. The final line provides the amount of time for the buyer to obtain the letter of credit and for the bank to notify the seller of its issuance. If the buyer delays in obtaining the credit past the time allowed, then the seller may reject the credit and hold the buyer in breach of the contract.

The letter of credit (bank guarantee) requirement in an export contract produces a number of contractual relationships. The purchaser enlists the services of its commercial bank by way of a letter of credit application. If the bank accepts the application, it issues the letter of credit. The application forms the basis of the contract between the applicant or account party (buyer) and the **issuing bank**. Once the issuing bank issues the letter of credit to the exporter, the exporter is called the **beneficiary party**. The letter of credit itself fixes the issuing bank’s obligations to the beneficiary party. Most often an intermediary bank located near the seller or the port of shipment is used to process the documents. If that bank confirms the letter of credit, then two additional contractual relationships are formed: between the **confirming bank** and the beneficiary, and between the confirming bank and the issuing bank. If the intermediary bank elects not to confirm or guarantee the letter, then it is referred to as an **advising bank**. It acts merely as a conduit for transmitting documents and payments. It has no independent legal obligation to the beneficiary party. A corresponding bank that confirms the letter of credit is independently liable for its payment.

It is important for the buyer to thoughtfully word the documentary requirements and the description of the goods in completing the letter of credit information. A review of the International Chamber of Commerce (ICC) forms and Guidance Notes will help the purchaser to draft instructions to the issuing bank and help the beneficiary (seller) to prepare the stipulated documents.

The typical letter of credit transaction follows a common chronology: (1) Seller and buyer agree on the terms of a sale; (2) buyer arranges for its bank to open a letter of credit; (3) buyer’s bank prepares and sends an irrevocable letter of credit, including instructions to the seller concerning required documents; (4) buyer’s bank

Account Party: The party requesting or applying for the letter of credit from a bank.

Advising Bank: A bank in the beneficiary's country through which the issuing bank communicates the credit to the beneficiary—sometimes referred to as the correspondent or nominating bank.

Back-to-Back Letter of Credit: This term is used when a third bank agrees to issue a second letter of credit at the request of the beneficiary using the first credit as collateral. The second credit is often used to pay or secure the beneficiary's suppliers.

Beneficiary Party: The party for which favor the letter of credit is issued such as the exporter (seller) in an international sale of goods transaction.

Confirming Bank: The bank in the beneficiary's country that further guarantees the issuing bank's commitment to pay the letter of credit.

Documentary Collection: The use of the banking system for an exporter to transfer documents to purchaser and to receive payment. The bank does not transfer the documents to the purchaser unless the purchaser makes payment or accepts a draft. The bank does not act as a guarantor of payment as in the documentary credit transaction.

Documentary Credit (letter of credit): An instrument requiring a bank to pay a sum of money to the beneficiary against the presentation of documents stipulated in the letter of credit. Used most commonly as a payment mechanism for export sales.

Factoring: The exporter sells its rights to receive payment to a factoring company. The factoring company discounts the amount

of the payment owed to the exporter in order to produce the desired rate of return. Used in short-term financing.

Forfaiting: The use of a draft or promissory note given by the purchaser (guaranteed by purchaser's bank) to the exporter to obtain nonrecourse financing. The terms are negotiated in advance so that the exporter is assured of payment before shipping the goods. The importer assumes the costs of discounting the note or draft. Used in long-term financing.

Red Clause Financing: This is where the seller-exporter is allowed to receive an advance on the letter of credit prior to presenting the required documents. The red clause represents a form of unsecured financing offered by the purchaser to a trusted exporter.

Standby Letter of Credit: A type of credit issued as a guarantee against default by one of the parties to the contract. Generally used to guarantee the performance (not payment) of one of the parties and paid only upon default (nonperformance), it acts as a standby. Alternative devices that serve the same purpose are the bank guarantee and the performance bond.

Transferable Credit: The beneficiary party, in whole or part, can transfer a transferable credit to secondary beneficiaries. An exporter may transfer the credit in order to finance the manufacture or purchase of the goods to be exported. The UCP requires that the original credit expressly provide for transferability. If it does not, the credit will be presumed to be nontransferable.

Uniform Customs and Practices for Documentary Credits (UCP): The international rules for letters of credit published by the International Chamber of Commerce in Paris. The current version is known as the UCP 600.

Figure 15.1 *Focus on Transactions*: Definitions of Key Letter of Credit and Finance Terms.

confirms the letter of credit; (5) seller arranges with the freight forwarder the delivery of the goods to the appropriate port; (6) common carrier issues bill of lading to seller; (7) seller presents documents to the seller's bank (confirming bank); (8) if the documents are conforming, the confirming bank processes the draft and pays the seller; (9) seller's bank forwards the draft and other documents to the buyer's bank (issuing bank); (10) if the documents are in order, buyer's bank reimburses the seller's bank for payment on the draft; (11) buyer's bank presents the documents to buyer; (12) buyer pays on the draft; (13) buyer presents bill of lading to the common carrier; and (14) common carrier delivers goods to buyer. See Figure 15.2 *Focus on Transactions*: "Confirmed Letter of Credit Transaction."

The typical scenario in an export transaction is that the seller and buyer negotiate a contract in which the buyer agrees to provide the seller with a letter of credit. Prior to signing a contract, the importer may seek advice from a **customs broker** regarding import regulations and the documents that it should require from the seller for import purposes. After the execution of the contract, the buyer places an application for the letter of credit with the prospective issuing bank. Following credit approval, the bank issues the original letter of credit using the details supplied in the letter of credit application.

The original letter of credit is forwarded (mail, telex, or SWIFT)¹ to the exporter's bank. The exporting bank then advises the exporter (beneficiary party) that the letter of credit has been issued. If required, the exporter's bank may also confirm the letter of credit. In order to ensure that the letter of credit is to be confirmed by a local bank, the exporter should negotiate clear language in the contract. The following clause provides for an irrevocable, confirmed letter of credit:

The Letter of Credit is to be drawn in IRREVOCABLE form and be subject to the Uniform Customs and Practices for Documentary Credits (UCP) as published and updated from time to time by the International Chamber of Commerce. The Letter of Credit must be advised through and CONFIRMED

by a bank located at the port of shipment acceptable to the seller. It must be PAYABLE AT THE COUNTERS OF THE CONFIRMING BANK.

The above clause expressly makes the UCP the choice of law and requires payment upon presentation of the documents to the confirming bank. This is especially important to the exporter wanting to receive payment as soon as practicable. The UCP is incorporated by reference into most banks' application and letter of credit forms. Letters of credit in the United States are generally regulated under Article 5 of the Uniform Commercial Code.

Upon receiving a letter of credit, the exporter should carefully compare the letter's terms with the terms of the exporter's *pro forma* invoice or price quotation. The exporter must provide documentation showing that the goods were shipped by the date specified in the letter of credit or it risks not being paid. Exporters should check with their freight forwarders to make sure that no unusual conditions may arise that would delay shipment. In addition, documents must be presented by the date specified in the letter of credit.

Following approval by the beneficiary, the bank is instructed to send the letter of credit to the freight forwarder with instructions to book shipment. The **freight forwarder** coordinates the movement of the goods, secures the bill of lading, and completes other documentation as required in the letter of credit. Generally, to initiate a relationship with a freight forwarder, the exporter completes a **power of attorney** form. The power of attorney allows the freight

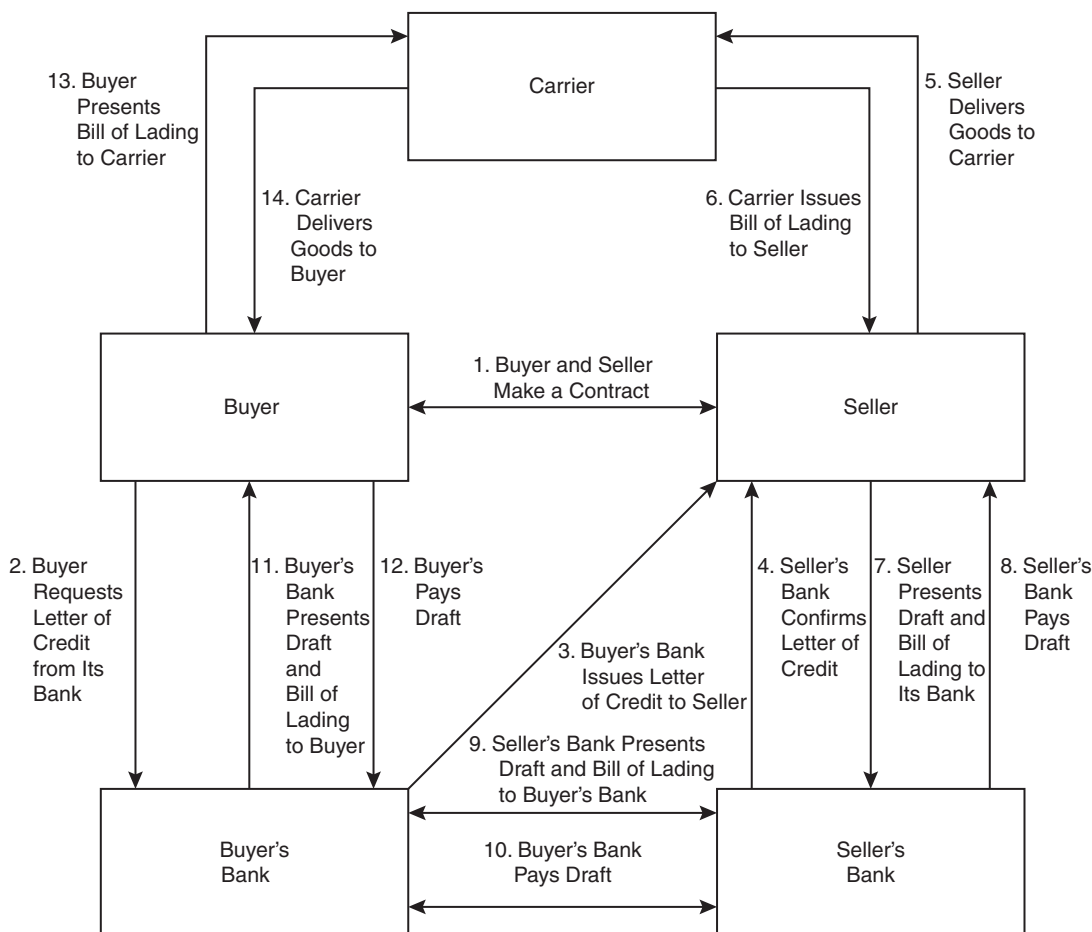


Figure 15.2 Focus on Transactions: Confirmed Letter of Credit Transaction.

forwarder to complete documents in the name of the exporter. The form must be signed by an authorized signatory of the exporter and witnessed by two people.

The original letter of credit and the shipping documents are presented to the advising or confirming bank. If the bank has confirmed the letter of credit, then it will review the documents and pay the exporter. The documents are then sent to the issuing bank with a claim for reimbursement. Upon its approval of the documents, the issuing bank will debit the importer's account for the amount of the letter of credit and any charges due. Following payment, the importer may instruct the bank to forward the documents to a customs broker. The customs broker secures the release of the goods by clearing them through customs. The customs broker will require, among other items, a commercial invoice and a properly endorsed bill of lading for import clearance purposes.

An exporter is often not paid until the advising or confirming bank receives the funds from the issuing bank. To expedite the receipt of funds, wire transfers may be used. Bank practices vary, however, and the exporter may be able to receive funds by discounting the letter of credit at the bank, which involves paying a fee to the bank. Exporters should consult with their international bankers about bank policy.

A letter of credit is especially useful when reliable credit information about a foreign buyer is difficult to obtain, but the exporter is satisfied with the creditworthiness of the buyer's bank. Another use of the letter of credit is that it allows the seller to securely defer payment by the buyer. This period may be as long as 180 days. Between trusted parties when a letter of credit is not cost-effective, alternatives may be sought to secure payment. The documentary transaction without a letter of credit, where payment is through a **sight** or **time draft**, is utilized. A draft is simply a check drawn on the account of the purchaser. A sight draft allows the seller to "cash" the draft immediately on presenting the documents to the bank or purchaser. A time draft, like a postdated check, can be cashed only some time after the presentation of the documents, most commonly 30, 60, or 90 days. The draft may be sued upon independent of the underlying export contract.

Payment under a documentary letter of credit is based on documents, not on the terms of sale or the condition of the goods sold. Before payment, the bank responsible for making payment verifies that all documents are exactly as required by the letter of credit. When they are not as required, a discrepancy exists, which must be cured before payment can be made. Common inconsistencies include different descriptions of the goods or quantities stated in the commercial invoice, packing slips, inspection certificate, and other documents. Inconsistencies also alert the custom authorities, triggering additional inspections of the goods and delaying the importation of the goods. Figure 15.3 *Focus on Transactions*: "Documentary Letter of Credit" provides an example of a typical "documentary letter of credit." The important things to note include that: (1) it states an expiration date as required by the UCP 600 (120 days from date of issue; that being September 1, 2015); (2) it expressly states that it is irrevocable (would be implied if not stated); (3) it expressly states that it is transferrable (would not be implied if not stated); (4) it notes that payment is at sight (cash against documents); it provides a list of six documents, along with the sight draft, to be presented by the seller-exporter; (5) it provides for payment by wire transfer; (6) it states that the governing regulations will be the UCP 600 (would be implied if not stated); and (7) the choice of law is the United Kingdom.

Importers that repeatedly require the issuance of letters of credit and who have strong banking ties often obtain a **revolving letter of credit**, which offers the convenience of requesting letters of credit without the need to apply for each one.

Revolving Letter of Credit: This arrangement allows the buyer to obtain multiple letters of credit up to a stated limit. After existing letters of credit expire, the amount available for future letters of credit is restored. This arrangement is highly efficient for a buyer who is doing multiple contracts at a time and over time. The buyer can get an immediate issuance of a letter of credit instead of having to apply for each individual letter of credit.

The *Voest-Alpine International v. Chase Manhattan Bank* case that follows describes a typical letter of credit transaction and introduces the **rule of strict compliance**. The rule of strict compliance is the standard by which

<p>Face Value: \$10,000,000 (Ten Million USD) Date of Issue: September 1, 2015 Place of Issue: Bank of Monrovia Branch of Issue: 1 Madison Avenue, Danubia, Monrovia Expiration Date: 120 days from date of issue Letter of Credit Number: 153676-777789 Beneficiary Party: ABC Exporting, Münsterland, Germany We, Bank of Monrovia, Branch 1 Madison, Avenue, have opened an unconditional, irrevocable, transferable Letter of Credit Number: 153676-777789 in favor of Beneficiary ABC Exporting in the amount of USD \$10,000,000 (Ten Million US Dollars) valid for a period of 120 days from date of issue September 1, 2015. This letter of credit is effective immediately and expires at our office in 120 days of issuance. Funds under this Letter of Credit against a sight draft drawn on us and demanding payment under "Letter of Credit Number 153676-777789." Along with the sight draft the following documents must be provided:</p> <ol style="list-style-type: none"> 1 Commercial Invoice (description to be identical to the description provided herein) 2 Clean Ocean Bill of Lading (marked freight prepaid) 	<ol style="list-style-type: none"> 3 Certificate of Insurance (in an amount equal to the amount stated on the Commercial Invoice and date prior to the date of the Bill of Lading) 4 Inspection Certificate (issued by the Association of Widget Manufacturers International and dated prior to the loading of the multimodal container) 5 Packing List 6 Consular Invoice issued by the Government of the Country of Monrovia <p>The Bank of Monrovia will pay under this Letter of Credit with its own funds by wire transfer to the account noted in the Sight Draft. Payment under this Letter of Credit will be free of any fees and charges of any kind. All charges are to be drawn from the account of the Applicant.</p> <p>This Letter of Credit is governed by the UCP 600 (Uniform Customs and Practices for Documentary Credits) as published by the International Chamber of Commerce in Paris, France. The laws of the United Kingdom shall govern all other matters not governed by the UCP 600. For and On Behalf of the Bank of Monrovia _____ Authorized Bank Officer.</p>
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Figure 15.3 *Focus on Transactions*: Documentary Letter of Credit.

banks review documents being presented for payment under a letter of credit. The UCP allows a bank to reject any nonconformity or discrepancy between the document being reviewed and the letter of credit requirements. The rule of strict compliance should not be confused with the independence principle or **facial compliance rule**. The facial compliance rule refers to the principle that a bank's only obligation in a letter of credit transaction is to review documents. Under the facial compliance rule, a bank is free to disregard any information, even about a fraud in the transaction that comes from a source outside of the documents. The rule of strict compliance is simply the standard by which the banks review documents.

The *Voest-Alpine v. Chase Manhattan* case illustrates a number of other important items. First, a number of expiration dates exist in most international export transactions. The documents were presented before the expiration of the letters of credit. The documents were untimely, however, because the letter of credit requirements stated that an on-board bill of lading had to be acquired on or before January 31. The UCP also provides another type of expiration date. The **21-day rule** states that the bill of lading, and accompanying documents, must be presented to the bank within 21 days from their procurement. If the exporter obtains the bill of lading and delays presentation past the 21 days, then the letter of credit expires even though the expiration date on the letter has not passed. The UCP rules will be discussed in greater depth later in this chapter.

The second item highlighted in the above case is the **bill of exchange** or **draft**.² The draft was previously discussed in Chapter 14 but will be briefly reviewed again here. The draft is a collections instrument that acts very much like a check. It is the mechanism for payment through the banking system. When a seller presents

Voest-Alpine International v. Chase Manhattan Bank

707 F.2d 680 (2d Cir. 1983)

Cardamone, Circuit Judge. Originally devised to function in international trade, a letter of credit reduced the risk of nonpayment in cases where credit was extended

to strangers in distant places. Interposing a known and solvent institution's (usually a bank's) credit for that of a foreign buyer in a sale of goods transaction

accomplished this objective. A typical letter of credit transaction, as the case before us illustrates, involves three separate and independent relationships—an underlying sale of goods contract between buyer and seller, an agreement between a bank and its customer (buyer or account party) in which the bank undertakes to issue a letter of credit, and the bank's resulting engagement to pay the beneficiary (seller) providing that certain documents presented to the bank conform ["strict compliance rule"] with the terms and conditions of the credit issued on its customer's behalf.

Significantly, the bank's payment obligation to the beneficiary is primary, direct, and completely independent of any claims that may arise in the underlying sale of goods transaction [independence principle or "facial compliance rule"]. Further, employing concepts which underlie letters of credit in non-sale of goods transactions enables these devices to serve a financing function. And it is this flexibility that makes letters of credit adaptable to a broad range of commercial uses.

Since the great utility of letters of credit arises from the independent obligation of the issuing bank, attempts to avoid payment premised on extrinsic considerations—contrary to the instruments' formal documentary nature—tend to compromise their chief virtue of predictable reliability as a payment mechanism. Viewed in this light it becomes clear that the doctrine of strict compliance with the terms of the letter of credit functions to protect the bank that carries the absolute obligation to pay the beneficiary. Adherence to this rule ensures that banks, dealing only in documents, will be able to act quickly, enhancing the letter of credit's fluidity. Literal compliance with the credit therefore is also essential so as not to impose an obligation upon the bank that it did not undertake and so as not to jeopardize the bank's right to indemnity from its customer. Documents nearly the same as those required are not good enough.

Metal Scrap Trading Corporation (MSTC) is an agency of the Indian government that had contracted to buy 7,000 tons of scrap steel from Voest-Alpine International Corporation (Voest), a trading subsidiary of an Austrian company. In late 1980 MSTC asked the Bank of Baroda to issue two letters of credit in the total amount of \$1,415,550—one for \$810,600 and the other \$604,950—to Voest to assure payment for the sale. The credits were expressly made subject to the Uniform Customs and Practice for Documentary Credits. The parties originally contemplated that Chase Manhattan Bank, N.A. (Chase or Bank), would serve as an advising bank in the transaction. As such, Chase was to review documents submitted by

Voest in connection with its drafts for payment. Amendments to the letters of credit increased Chase's responsibilities and changed its status to that of a confirming bank, independently obligated on the credit to the extent of its confirmation.

The terms and conditions of the credits required proof of shipment, evidenced by clean-on-board bills of lading; certificates of inspection indicating date of shipment; and weight certificates issued by an independent inspector. Sometime between February 2 and February 6 (beyond the January 31 deadline), the cargo was partially loaded aboard the M/V *Atra* at New Haven. Unfortunately, the *Atra* never set sail for India. A mutiny by the ship's crew disabled the ship and rendered it unseaworthy. The scrap steel was later sold to another buyer for slightly over a half million dollars, nearly a million dollars less than the original contract price.

On February 13, two days before the expiration date of the credits, Voest presented three drafts with the required documentation to Chase. The bills of lading indicating receipt on board of the scrap metal were signed and dated January 31 by the captain of the *Atra*. The weight and inspection certificates accompanying the drafts revealed, however, that the cargo was loaded aboard the *Atra* sometime between February 2 and February 6. Despite this glaring discrepancy Chase advised the Bank of Baroda on February 25 that the drafts and documents presented to it by Voest conformed to the terms and conditions set forth in the letters of credit.

The Bank of Baroda apparently looked at the documents with more care than Chase. It promptly advised Chase that the documents did not comply with the requirements of the letters of credit, that it would therefore not honor the drafts, and that it would hold the documents at Chase's disposal. When Voest presented the drafts for payment on July 30 Chase refused to honor them. Voest thereupon instituted the present suit. It asserted that Chase waived the right to demand strict compliance with the terms of the credits and therefore wrongfully dishonored the drafts. Voest further alleged that regardless of whether the documents conformed to the letters of credit Chase was liable on the drafts because it accepted them.

A. Acceptance

Claims by a beneficiary of a letter of credit that a bank has waived strict compliance with the terms of the credit should generally be viewed with a somewhat wary eye. Acceptance is the drawee's signed engagement to honor the draft as presented and that it "must be written on the draft." By requiring written acceptance on the draft

Section 3–410 of the Uniform Commercial Code impliedly eliminated oral acceptances as well. The present record is silent as to whether Chase actually accepted the drafts by proper notation on them.

B. Fraud

Presentation of fraudulent documents to a bank by a beneficiary subverts not only the purposes which letters of credit are designed to serve in general, but also the entire transaction at hand in particular. Falsified documents are the same as no documents at all.

We AFFIRM the judgment in favor of the Bank of Baroda. All parties have acknowledged that the documents tendered Chase did not conform to the established terms and conditions of the letters of credit. The Bank of Baroda, as the issuing bank, was entitled to strict compliance and there is no claim that it waived that right.

Case Highlights

- A typical letter of credit transaction comprises a number of contractual relationships, including between the buyer (account party) and its bank (issuing bank), between the issuing bank and the seller (beneficiary), and between the issuing bank and a corresponding bank (confirming bank).
- A confirming bank owes an independent obligation to the beneficiary party.
- The rule of strict compliance protects banks by allowing them to reject documents because of discrepancies.
- A bank is liable for payment if it “accepts” a draft. However, legal acceptance of a draft may be done only by a written endorsement on the draft (Uniform Commercial Code § 3–410).

documents for payment on a letter of credit, it presents the bank with a draft drawn on the letter of credit. The draft is an order to the drawee (bank or account party) to pay. The difference between a draft and an ordinary check is that in the documentary draft the seller acts as both the drawer and the payee. The **Uniform Law on Bills of Exchange** states that “a bill of exchange or draft contains an unconditional order to pay a determinate sum of money; the name of the person who is to pay (drawee); the time of payment; the place of payment; the name of the person to whom or to whose order payment is to be made (payee); and the signature of the person who issues the bill (drawer).”

The two general types of drafts used in export transactions are the sight draft and the time draft. A sight draft requires payment immediately upon the presentation of the documents. A draft in which the time of payment is not specified is deemed payable at sight. If a period of time were entered into the blank following “Sight Days After,” then the draft would be converted into a time draft. See Figure 15.5 *Focus on Transactions: “Banker’s Acceptance”* on page 472 for an example of a time draft. Behind Citibank’s titled “Acceptance” stamp there is the number 120, which is part of a line that reads “120 days after SIGHT,” meaning payment is due 120 days after delivery of documents to the bank by the seller.

As noted in Chapter 14, electronic bills of lading and letters of credit are technologically possible. In reality, most sellers still prefer a hard copy of the letter of credit. So an entirely paperless letter of credit transaction is possible, but in reality not common. However, letter of credit transactions between banks (issuing, confirming, advising) have become purely electronic. For example, an issuing bank will electronically send the letter of credit to the confirming bank. The confirming bank will issue to the beneficiary party (seller) a paper letter of credit or a notice that the letter of credit has been issued. The electronic communications between banks are processed through SWIFT (Society for Worldwide Interbank Financial Telecommunication).

If the exporter wants to extend credit to the buyer, a time draft can be used to state that payment is due within a certain time after the buyer accepts the draft and receives the documents. By signing and writing “accepted” on the draft, the buyer is formally obligated to pay within the stated time. When this is done the draft is called a **trade acceptance** and can be either kept by the exporter until maturity or sold to a bank at a discount for immediate payment. **Acceptance** creates an independent obligation on the acceptor (drawee). The independence of the acceptance obligation means that the obligation can be enforced by subsequent holders of the instrument without regard to the buyer’s rights under the sales contract. In short, the acceptance converts the draft into a negotiable instrument. When a bank accepts a draft, the draft becomes an obligation of the bank and a negotiable instrument

Interpane Coatings v. Australia & New Zealand Banking Group

732 F. Supp. 909 (N.D. Ill. 1990)

Kocoras, District Judge. Underlying this litigation is an international sale of goods run amuck. Interpane, a Wisconsin corporation and the seller in this transaction, delivered the goods to an Australian buyer who then did not pay despite having accepted the goods as well as having endorsed three bills of exchange. In this action, Interpane seeks to hold ANZ, the designated collecting bank in the transaction, liable for its failure to obtain the money from the buyer.

The relevant facts are as follows: Interpane and an Australian entity named McDowell Pacific Pty., Ltd., entered into a contract for the sale of goods whereby Interpane was to ship goods to Australia and McDowell was to pay for them. As is usual in such cases where delivery and payment are to occur at a distant point, the seller used bills of exchange and bills of lading rather than simply shipping the goods to the buyer in Australia with an invoice (open account).

By using this procedure, Interpane reduced the critical transactional points of tender and acceptance to a mere documentary transfer that made acceptance of the bills of exchange a condition precedent to tender. But to do so required the aid of middlemen in the form of banks. The banks involved in the transaction were ANZ and the Chicago branch of Swiss Bank Corporation. ANZ, McDowell's bank, was to act as the presenting and the collecting bank. Swiss Bank was designated Interpane's local representative, forwarding and receiving the relevant documents on behalf of Interpane. It was also the named payee on the bills of exchange. Under the documentary procedure used in this case, Interpane sent ANZ three bills of exchange accompanied by three bills of lading. The bills of exchange were all time drafts with payment to be due 60 days from McDowell's "seeing" them; such bills are called time drafts in order to distinguish them from sight drafts which are actually payable on sight.

There are two principal types of collection orders, those that require mere acceptance by the drawee/buyer and those which require actual payment. If acceptance is required, the collecting bank need only obtain the endorsement of the drawee/buyer before releasing the title documents. By accepting the bills of exchange, the drawee acknowledges the debt and commits to making payment as required by the bill of exchange (in this case 60 days from sight). As the designated collecting bank, ANZ had a contractual duty to follow Interpane's collection orders. Interpane alleges that ANZ breached this contractual duty by not obeying its special instructions, which it alleges required ANZ to endorse the bills of exchange as a guarantor, thus converting them into banker's acceptances, before releasing the title documents to McDowell.

Case Highlights

- Banks play an intermediary role in effecting the transfer of documents and payments relating to the export transaction.
- Documentary collection transactions condition the release of documents on acceptance or payment of the documentary draft by the buyer.
- Bills of exchange or drafts are the means by which an exporter obtains payment in an international sale of goods transaction.
- Bills of exchange or drafts are orders by the drawer (exporter) to the buyer or buyer's bank (drawee) to pay the exporter (payee). It differs from a check only in that the drawer and the payee are the same party (exporter).
- A time draft is a bill of exchange that requires payment sometime after the buyer accepts the documents.

known as a **banker's acceptance**. A banker's acceptance can be sold to a bank at a discount for immediate payment. The excerpt from the *Interpane Coatings v. Australia & New Zealand Banking Group* case describes the use of time drafts and the importance of acceptance.

Uniform Customs and Practices for Documentary Credits (UCP 600)

The UCP is a set of rules published by the ICC, the most recent compilation of which is the UCP 600. The UCP applies to letters of credit used to guarantee payment to an exporter in a documentary transaction. They may also be used in conjunction with standby letters of credit used to guarantee a performance. As mentioned earlier, the UCP is

incorporated in most international letter of credit transactions by references in the application forms supplied by commercial banks. Letters of credit used to guarantee payment to an exporter are called documentary credits. This name refers to the fact that payment under the letter of credit is contingent upon the presentation of documents by the exporter.

As discussed earlier, banks have the duty to use reasonable care in examining documents for conformity to the requirements of the letter of credit. If the documents are in facial compliance, then the bank pays the beneficiary party (exporter) through the letter of credit. The issuing bank must examine the documents within a reasonable time and notify the parties promptly of any nonconformity. The documents must comply strictly with the requirements of the letter of credit. Banks are not liable for accepting forged or false documents. The letter of credit instructions of the account party (buyer) should give precise details of the documents required. For example, a bill of lading must indicate that the goods have been loaded on board the named vessel. Insurance documents must be dated prior to the loading of the goods on board the ship. The description of the goods in the commercial invoice must be the same as the one contained in the letter of credit.

The sophisticated importer–purchaser should become familiar with the requirements and rules of the UCP 600. They have a direct bearing on how the applicant completes a letter of credit application. If the applicant places a non-customary term or instruction in the application, the banks will often disregard that instruction in favor of a default rule found in the UCP 600. The ICC has developed a number of standard documentary credit forms, along with “Guidance Notes” for their proper use. International purchasers and sellers should be familiar with the forms used to obtain and amend letters of credit. The ICC forms incorporate the requirements of the UCP. The latest revision of the rules, UCP 600, came into effect on July 1, 2007.

The Guidance Notes warn against the use of broad terminology to describe items of value or amounts of something. The most important point in filling out letter of credit forms is to be simple, clear, and precise in drafting the instructions to the bank. The use of words like *approximate* in association with the amount of the credit or the quantity or unit price of the goods will be automatically translated under Article 30(b). The buyer will have to accept documents that vary the amount of goods in the range of 5 percent, more or less. In order to avoid such a variance, the applicant will want to state a specific number of packing units or words to the effect that “the quantity of the goods specified must not be exceeded or reduced.”

A balance should be struck between filling out the letter of credit application completely and not using excessive detail. Excessive detail in the letter of credit application may lead to unnecessary confusion given the different cultures represented in many international transactions. An overly detailed letter of credit is apt to result in an increased likelihood of documents being rejected by the bank. The ICC manual makes these simple suggestions when filling out a letter of credit application: (1) Do not call for documents, which the Beneficiary cannot obtain. Article 14(h) deals harshly with such instructions. “If a Credit contains conditions without stating the documents to be presented in compliance therewith, banks will deem such conditions not stated and will disregard them.” (2) Do not require a document to contain detail, which is not within the issuer’s knowledge. (3) Do not state conditions whose observance cannot be ascertained from the face of a document.

Under the UCP, the applicant must request that the letter be confirmed. The applicant may designate the confirming bank or leave it to the discretion of the issuing bank. The identity of the confirming bank should have been agreed to between the exporter–beneficiary and the importer–applicant. An alternative is to insert “freely negotiable by any bank” or “freely negotiable credit.” This would allow the beneficiary to negotiate the documents at any bank willing to negotiate. The currency of the letter of credit should be designated using the ISO Currency Code, such as USD for U.S. dollars or CNY for Chinese yuan, also known as renminbi (RMB).

The applicant should provide transport details, including where the shipment is to be “taken in charge, dispatched, or loaded on board” and to where the shipment must be made (“at the place of unloading, delivery, or final destination”). The applicant should also state the latest date for shipment, dispatch, or taking in charge under the space next to the phrase “not later than” on the credit application. Otherwise, the time limit will be the date of expiration as provided in the UCP. If the applicant uses the phrase “on or about,” the UCP defines an acceptable period as five days before or after the specified date. Also, abbreviations for geographical

designation should be avoided. Full names should be used for all cities, states, provinces, countries, and so forth.

The UCP should be reviewed when determining the transport documents that will be required. There are different rules pertaining to two of the common transport documents, the ocean bill of lading (ocean leg of transport) and bills of lading issued by freight forwarders (multimodal). If the shipment entails the use of more than one mode of transportation, then the applicant should require a Multimodal Transport Document as described in the UCP for the goods in question.

The content of insurance documents is addressed under the UCP. If the applicant fails to state the amount of the insurance to be procured, then the UCP requires an amount equal to CIF value plus 10 percent. If the CIF value cannot be discerned from the documents, then the banks are likely to require 110 percent of the amount found in the commercial invoice. The applicant should specify the period of time when the documents need to be presented following shipment of the goods. If a period is not stipulated, then the UCP sets the period as 21 days from the date of shipment.

The description of the goods should generally be as brief as possible. In the above case, the result would have been different under the UCP if the letter of credit had not specifically stated that the bill of lading should have that particular description. The UCP requires only that the commercial invoice reflect the description found on the letter of credit. It states that “the description of the goods in the commercial invoice must correspond with the description in the Credit. In all other documents, the goods may be described in general terms not inconsistent with the description of the goods in the Credit.” Therefore, it is advisable to keep the description simple and clear. It should be noted that the use of terms like *about* or *approximately* in describing the quantity or unit price of the goods is defined under UCP Article 30(a) as a 10 percent tolerance.

The UCP 600 changes the rule for the time banks have to review the documents and employs a *single notice requirement*. The old rule stated that the reviewing bank had to review the documents within a “reasonable time” not exceeding five business days. The new rule rejects the flexibility of the reasonable time standard and adopts the fixed rule that a bank has five days to review the documents. This is a pro-bank change since under the old rule a reasonable time may be less than five days. This would happen when the bank rejects the documents as non-conforming. The seller could claim that the bank took too long to perform its review and lost its right to reject the documents. UCC Article 5 states that a bank must review the documents within a reasonable time not to exceed seven business days. The single notice rule states that a bank may only give one notice of the existence of discrepancies in the documents. If it sends a notice that the documents are conforming or that they contain a discrepancy, and subsequently finds a discrepancy or more discrepancies, the bank no longer has the right to give notice of those discrepancies even if the second notice is within the five-day review period.

Under the rule of strict compliance, banks are authorized to reject documents even if they are technically in conformity. An example of this is the use of abbreviations or acronyms in the description of goods. People in the industry may use such devices in corresponding between themselves. However, banks are not required to know or to investigate trade custom or usage. This was the situation in the historically significant English case of *J.H. Rayner & Co. v. Hambros Bank, Ltd.*³ in which the bank rejected a bill of lading that used the notation “CRS” in describing the goods. In the nut industry, CRS is the abbreviation for “Coromandel groundnuts.” The letter of credit required that the bill of lading state “Coromandel groundnuts.”

The accompanying invoice did use the full name. Nonetheless, the court upheld the bank’s right to reject the documents. Two rationales were given. First, “that even though the description of the goods in the bill of lading was correct in accordance with the custom of trade, the bank could not be held to be affected with a knowledge of the customs of the various trades in which its customers might be concerned.” Second, even if the bank possessed knowledge of the trade custom or usage, it must do exactly what its customers require it to do. There may be some unknown reason why the account party (importer) wants the documents to be detailed in a certain way. It is not for the bank to impose common sense to abrogate a specific instruction in the letter of credit. The application of the rule of strict compliance is the key issue in *Courtaulds North America v. North Carolina National Bank*.

For the reasons described in the preceding paragraph, the description of the goods should generally be as brief as possible. In the above case, the result would have been different under the UCP if the letter of credit had not

Courtaulds North America v. North Carolina National Bank**528 F.2d 802 (4th Cir. 1975)**

Bryan, Circuit Judge. A letter of credit with the date of March 21, 1973, was issued by the North Carolina National Bank at the request of and for the account of its customer, Adastra Knitting Mills, Inc. It made available upon the drafts of Courtaulds North America, Inc., “up to” \$135,000 at “60 days date” to cover Adastra’s purchases of acrylic yarn from Courtaulds. The life of the credit was extended in June to allow the drafts to be “drawn and negotiated on or before August 15, 1973.” The Bank refused to honor a draft for \$67,346.77 dated August 13, 1973, for yarn sold and delivered to Adastra. Courtaulds brought this action to recover this sum from Bank.

The Bank denied liability chiefly on the assertion that the draft did not agree with the letter’s conditions that the draft be accompanied by a commercial invoice stating that it covers “100% acrylic yarn”; instead, the accompanying invoices stated that the goods were “Imported Acrylic Yarn.” The District Court held defendant Bank liable to Courtaulds for the amount of the draft, interest, and costs. It concluded that the draft complied with the letter of credit when each invoice is read together with the packing lists stapled to it, for the lists stated on their faces: “Cartons marked: - 100% Acrylic.” After considering the insistent rigidity of the law and usage of bank credits and acceptances, we must differ with the District Judge and uphold the Bank’s position.

On Monday, August 20, Bank called Adastra and asked if it would waive the discrepancies and thus allow Bank to honor the draft. Courtaulds on August 27 sent amended invoices to Bank which were received by Bank on August 27. They referred to the consignment as “100% Acrylic Yarn,” and thus would have conformed to the letter of credit had it not expired. On August 29 Bank wired Courtaulds that the draft remained unaccepted because of the expiration of the letter of credit on August 15. “The only issue presented by the facts of this case is whether the documents tendered by the beneficiary to the issuer were in conformity with the terms of the letter of credit.” The letter of credit provided: “Except as otherwise expressly stated herein, this credit is subject to the Uniform Customs and Practice for Documentary Credits (UCP).” Of particular pertinence are these provisions of the UCP:

Article 7. Banks must examine all documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit.

Article 8. In documentary credit operations all parties concerned deal in documents and not in goods. If, upon receipt of the documents, the issuing bank considers that they appear on their face not to be in accordance with the terms and conditions of the credit, that bank must determine, on the basis of the documents alone, whether to claim that payment, acceptance, or negotiation was not effected in accordance with the terms and conditions of the credit.

Article 9. “Banks . . . do [not] assume any liability or responsibility for the description, . . . quality, . . . of the goods represented thereby. The description of the goods in the commercial invoice must correspond with the description in the credit. In the remaining documents the goods may be described in general terms.

In utilizing the rules of construction embodied in the letter of credit, the UCP states that one must constantly recall that the drawee bank is not to be embroiled in disputes between the buyer and the seller, the beneficiary of the credit. The drawee is involved only with documents, not with merchandise. Its involvement is altogether separate and apart from the transaction between the buyer and seller; its duties and liability are governed exclusively by the terms of the letter, not the terms of the parties’ contract with each other. Moreover, as the predominant authorities unequivocally declare, the beneficiary must meet the terms of the credit—and precisely—if it is to exact performance of the issuer. Failing such compliance there can be no recovery from the drawee. That is the specific failure of Courtaulds here. “There is no room for documents which are almost the same, or which will do just as well.”

At trial Courtaulds prevailed on the contention that the invoices in actuality met the specifications of the letter of credit in that the packing lists attached to the invoices disclosed on their faces that the packages contained “cartons marked: - 100% acrylic.” In this connection it is well to revert to the distinction made in the UCP between the “invoice” and the “remaining documents,” emphasizing that in the latter the description may be in general terms while in the invoice the goods must be described in conformity with the credit letter. Bank was not expected to scrutinize the collateral papers, such as the packing lists. Nor was it permitted to read into the

instrument the contemplation or intention of the seller and buyer. Had the Bank deviated from the stipulation of the letter and honored the draft, then at once it might have been confronted with the not improbable risk of the bankruptcy trustee's charge of liability for unwarrantably paying the draft to the seller. REVERSED AND REMANDED.

Case Highlights

- Article 7 of the UCP requires that banks review required documents for facial compliance. Banks are

not required to know or to research trade custom or usage.

- Article 8 (strict compliance rule) allows for banks to reject documents that do not comply on their face.
- Article 9 requires that the description of the goods in the commercial invoice must strictly correspond to the description in the letter of credit. Descriptions in other documents may be made with more general terms.
- Even if a bank wants to accept an inexact description in the commercial invoice, it is precluded from doing so if the letter of credit expressly states otherwise.

specifically stated that the bill of lading should have that particular description. The UCP requires only that the commercial invoice reflect the description found on the letter of credit. Article 18 states that “the description of the goods in the commercial invoice must correspond with the description in the Credit. In all other documents, the goods may be described in general terms not inconsistent with the description of the goods in the Credit.” Therefore, it is advisable to keep the description simple and clear. Figure 15.4 *Focus on Transactions: “Ten Rules Pertaining to International Letters of Credit (LOC)”* further summarizes the rules governing letters of credit.

<p>Rule of Facial Compliance</p> <p>Banks are only required to review documents Banks only review documents listed on LOC application Banks are not liable for “fraud in the transaction” (Even if aware of the fraud)</p>	<p>If fails to deliver within 21 days, the LOC expires (LOC expires even if express date on LOC has not expired)</p>
<p>Banks Not Required to Know Trade Usage or Technical Terms</p> <p>Banks not required to know or investigate trade usage, customs, or commercial practices Banks not required to know meanings of abbreviations</p>	<p>Bank Has 5 Days to Review Documents</p> <p>If fails to review within allotted time, the documents are deemed to be conforming</p>
<p>Rule of Strict Compliance (Standard of Review)</p> <p>Banks may reject any “discrepancies” in the documents unless discrepancy is <i>de minimis</i> (unreasonable or in bad faith to reject)</p>	<p>Presumption of Irrevocability</p> <p>If LOC is silent, then it is presumed to be irrevocable (Period of time affixed by expiration date or by running of 21-day rule)</p>
<p>LOC Must Have Express Expiration Date</p> <p>If expiration date is missing, then LOC is unenforceable</p>	<p>Insurance Certificate</p> <p>Must be dated no later than the date of loading of goods (issuance of bill of lading) Must be in an amount of 110 percent of CIF value (unless parties agree otherwise)</p>
<p>21-Day Rule</p> <p>Beneficiary party (seller) must deliver documents within 21 days of obtaining the bill of lading</p>	<p>Commercial Invoice</p> <p>Must include exact description of goods as provided on LOC application</p>
	<p>LOC is Presumed to be Non-transferable (unless LOC states otherwise)</p>

Figure 15.4 *Focus on Transactions: Ten Rules Pertaining to International Letters of Credit (LOC).*

(Uniform Customs and Practices for Documentary Credits—UCP 600.)

Table 15.1 *Focus on Transactions: UCP 600 Rules*

UCP Article	Description and Rules
17. Original Documents	At least one original document required; letter of credit (L/C) requires only copies.
18. Commercial Invoice	Issued by beneficiary to the Applicant; need not be signed; same currency as L/C; description of goods must match the description in the L/C.
19. Multimodal Transport Document	At least two modes of transport; must name carrier of agent. Example: XYZ Forwarders as Agent of "Master" of Common Carrier; must indicate "transshipments" (reloading from one means to another means of conveyance).
20. Bill of Lading	Must be signed by master or agent; state "on-board"; all originals required; transshipment from one ship to another need not be stated as long as both ships are covered by same bill of lading.
24. Road, Rail, or Inland Waterway	Must state date of issuance or when goods received for shipment; indicate places of shipment and destination as noted in L/C.
27. "Clean" Transport Document	Clean transport document is one bearing no clause or notation declaring defective condition of goods or packaging; word "clean" need not appear on document even if L/C requires "clean on-board."
28. Insurance Document and Coverage	Insurance certificate or policy; signed by insurance company, agents, or proxies; issued no later than the shipment date (must be dated on or before the date on the bill of lading); minimum coverage is 110 percent of CIF or CIP value unless L/C indicates a different value; L/C should state type of risks covered: if L/C states "customary risks" banks will accept any type of coverage; if L/C states "all risks" then the insurance document must note that it is "all risks."
29. Expiration of L/C	If last day falls on a day the bank is closed, then extended to the next banking day; latest day of shipment will not be extended.
30. Tolerance in Amounts and Prices	If the L/C uses words such as "approximately" or "about," then amount, quantity, or unit prices stated on the documents may vary 10% more or less.
33. Hours of Presentation	Bank has no obligations to accept documents outside its normal banking hours.

Rule 6 in the *Focus on Transactions* figure notes that banks have a reasonable time to review documents not to exceed seven days under the Uniform Commercial Code⁴ and five days under UCP 600. If the bank accepts nonconforming documents, then it may sue the beneficiary party if it proceeds in a timely fashion. This was the issue in *Habib Bank Ltd. v. Convermat Corp.*⁵ In that case, the bank paid on documents that included a bill of lading with a discrepancy in the shipping date. The account party subsequently rejected the documents. The bank waited a month before making a claim against the beneficiary party. The court held that the claim was not made in a timely fashion and dismissed the action. Article 16(d) requires the bank to give notice "by expeditious means" and such notice "must state *all* discrepancies in respect of which the bank refuses the documents."

Articles 19–24 of the UCP should be reviewed when determining the transport documents that will be required. The rules pertaining to two of the more common transport documents, the multimodal and the ocean bills of lading are found in Articles 19 and 20.

The content of insurance documents is addressed in Articles 28 of the UCP. If the applicant fails to state the amount of the insurance to be procured, then Article 28(f)(2) of the UCP requires an amount equal to CIF value plus 10 percent. The applicant should specify the time by which the documents need to be presented following shipment of the goods. If a period is not stipulated, then Article 14(c) sets the period at 21 days from the date of shipment. Table 15.1 *Focus on Transactions: "UCP 600 Rules"* reviews some of the rules used in determining the conformity of certain documents and the timeliness of the presentation of the documents.

Other important UCP rules relating to the description of the goods are found in Articles 14(e) and 18(c). Article 14(e) involves the description of the goods in the various documents. The general rule is that the description in the commercial invoice must be the same as that found in the letter of credit; descriptions in other documents may be more general in nature so long as they do not conflict with the more detailed description found in the letter of credit or commercial invoice. Article 18(c) re-emphasizes that: "The description of the goods, services or performance in

a commercial invoice must correspond with that appearing in the credit.” However, there is no requirement for a mirror image description between the letter of credit and the commercial invoice. For example, details of the goods may be stated in a number of areas within the invoice which, when collated together, represents a description of the goods corresponding to that in the credit.

International Standard Banking Practice (ISBP)

Figures show that about 25 percent of banks are taking a strict compliance approach in order to minimize their risks. Another ICC instrument aimed at reducing the number of rejections is the *International Standard Banking Practice (ISBP) for the examination of documents under documentary credits* (ICC Publication 645). These rules have been universally accepted by the world banking system and, therefore, a basic knowledge of its requirements is necessary for all exporters–importers involved in a documentary credit transaction. ISBP was conceived as an intelligent checklist of procedures for document checkers to follow in examining the documents presented under letters of credit. While not a substitute for the UCP, which remains the guiding text, the *ISBP* demonstrates how the UCP is to be integrated into day-to-day practice.

Payment Systems

SWIFT is the Society for Worldwide Interbank Financial Telecommunication,⁶ a member-owned cooperative through which the financial world conducts its business operations with speed, certainty, and confidence. More than 10,800 banking organizations, securities institutions, and corporate customers in over 200 countries allow for the exchange of millions of standardized financial communications. SWIFT sees its role as providing a communications platform, products, and services that allow customers to exchange financial information securely. It also facilitates collaborative efforts by the financial community to shape market practice, define standards, and consider solutions to issues of mutual interest. SWIFT enables its customers to automate and standardize financial transactions, lowering costs and reducing operational risk. SWIFT provides customers with the means to explore new business opportunities.

Rise of Real-Time Digital Payments

The use of mobile technology for funds transfers has increased, as people have become used to sending mobile payments. Such systems offer speed, convenience, and safety. Over the same period, supply chain logistics have also improved, and the delivery of digital and physical goods has become much faster. There are two types of real-time immediate payment schemes: closed systems and RT-RPS. A closed system can be either through ‘on-us’ payments within a bank, or in a closed system such as PayPal, Alibaba, or BlueCash. However, both the payer and payee must both be users of the same closed system. RT-RPS means immediate transfer, confirmation, and ability for funds reuse, on a 24/7/365 basis. In a real-time retail payment system (RT-RPS), payments may be settled in central bank money, to mitigate credit risk.

Virtual Currencies

Virtual currency is, generally, a digital unit of exchange that is not backed by a government-issued legal tender. **Bitcoin** has become the most popular example of a virtual currency. The lower cost of Bitcoin assists small businesses by providing an alternative to expensive credit cards, enabling migrants to make cheaper remittances of payments to their families in developing countries, helping to protect individuals from censorship and capital controls, providing oppressed groups with financial privacy, and facilitating innovation and micropayments.

Bitcoin has not been recognized by any of the G20 countries as meeting the definition of currency as it lacks price stability and does not provide a stable store of value. Digital currencies are believed by the U.S. Secret Service to be

preferred by criminals because they offer a high degree of anonymity for users, allow for the movement of illicit proceeds from one country to another, and the widespread adoption in the criminal underground.⁷ FinCEN, a bureau of the U.S. Treasury Department, is charged with the power to investigate financial crimes involving the transmission of currencies and reports to the Office of Terrorism and Financial Intelligence. The FBI founded the Virtual Currency Emerging Threats Working Group (VCET) in 2012.

Standby Letters of Credit

An alternative to a performance bond issued by insurance companies to ensure performance (supply goods, perform services, construct a building) is the **standby letter of credit** issued by a commercial bank. Banks, by law, are prohibited from issuing performance bonds, so the standby letter of credit was developed as an alternative. The standby letter of credit is distinct from the documentary letter of credit. The latter is based on the proper performance of the parties, while the former is based upon improper or nonperformance. The ordinary letter of credit is used in the ordinary course of business—the parties’ intention is the seller will be paid upon its presentation of conforming goods or documents. Payment through a standby letter of credit is less commonly exercised since payment to the buyer is only triggered when there is nonperformance of the seller, service provider, or the construction company.

The UCP 600 and Article 5 of the American UCC also govern the standby letter of credit as compared to the documentary letter of credit. However, in the case of the UCP 600, it is a poor fit since the UCP was drafted to mainly deal with documentary letters of credit. Therefore, specialized rules have been developed for the standby letter of credit, including the 1995 UN Convention on Independent Guarantees and Stand-by Letter of Credit and the ICC’s International Standby Practices (ISP98). Unlike the numerous documents that are required to be provided by a seller to effectuate payment through the letter of credit, there is usually only one document that needs to be presented to receive payment under a standby letter of credit. That document is a simple demand by the beneficiary party (buyer) for payment due to nonperformance. The ISP recognizes the simplicity of the document

Itek Corp. v. First National Bank of Boston

730 F.2d 19 (1st Cir. 1984)

Breyer, Circuit Judge. The First National Bank of Boston (“FNBB”), at the request of Itek Corp., issued several letters of credit running in favor of Bank Melli Iran (“Melli”). Melli demanded payment from FNBB of the money that the letters promised. Itek obtained a federal district court injunction prohibiting FNBB from paying Melli. The basic question that Melli’s appeal presents is whether its effort to obtain the money by calling the letters is “fraudulent.”

The letters of credit arise out of promises made in a 1977 contract between Itek and Iran’s Imperial Ministry of War. The contract provided that Itek would make and sell high-technology optical equipment to the War Ministry at a price of \$22.5 million. Iran was to make a 20 percent down payment. It would pay Itek 60 percent of the total price (\$13.5 million) as work progressed; it would pay the remaining 20 percent upon satisfactory completion. The contract required Itek to provide two

types of bank guarantees. The first, the *down payment guarantee*, was to give the Ministry the right to obtain return of the down payment until Itek produced work of sufficient value. The second, the *good performance guarantee* was for \$2.25 million, 10 percent of the contract price. Its object was to protect the Ministry against a breach of contract. The Ministry could call for payment under the guarantees simply by submitting a written request for payment to the bank.

Bank Melli, an instrumentality of the Iranian government, issued the guarantees. Melli required Itek to provide it with similar “standby” letters of credit, issued by an American bank in Melli’s favor. The underlying contract provided that if the contract “is cancelled due to *Force Majeure*, all Bank Guarantees of good performance of work will be immediately released.” The contract defines *Force Majeure* to include cancellation by the United States of necessary export licenses. Itek’s work proceeded

uneventfully until Iran's government collapsed in early 1979. In April 1979 the United States suspended Iték's export license. Iték then proceeded to cancel the contract in accordance with the *Force Majeure* provisions. At that point, Melli demanded payment on the letters of credit.

Section 5-114(2)(b) of the Uniform Commercial Code authorizes a court to enjoin payment on a letter of credit when it finds "fraud in the transaction." It states that:

(2) Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document is forged or fraudulent or there is fraud in the transaction:

*(a) the issuer must honor the draft . . . if honor is demanded by . . . a holder in due course; and
(b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor.*

The basic legal question in this case is whether the circumstances surrounding Melli's calls on FNBB's letters of credit establish "fraud in the transaction." We answer this question fully aware of the need to interpret the "fraud" provision narrowly. The very object of a letter of credit is to provide a near foolproof method of placing money in its beneficiary's hands when he complies with the terms contained in the letter itself—when he presents, for example, a shipping document that the letter calls for or (as here) a simple written demand for payment. Despite

these reasons for hesitating to enjoin payment of a letter of credit, the need for an exception is apparent. Thus, in a leading case, a seller, contractually committed to ship bristles to a buyer, shipped rubbish instead. The court refused to allow the seller to call the letter, put the money in his pocket, and let the buyer sue him, for in the court's view, the seller did not even have a colorable claim that he had done what the contract called for as a precondition to obtaining the money, namely, ship the bristles. *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631 (Sup. Ct. 1941). If Melli has no plausible or colorable basis under the contract to call for payment of the letters, its effort to obtain the money is fraudulent and payment can be enjoined.

For these reasons, we find adequate support for the district court's conclusions that Melli was without a plausible legal basis for calling the letters of credit and that its call upon them, in the circumstances revealed in this record, constituted "fraud." The injunction therefore was properly issued. And the district court's order is AFFIRMED.

Case Highlights

- A letter of credit that is used to guarantee a performance or return of a deposit is called a standby letter of credit.
- A bank *may* honor a letter of credit when documents comply on their face even if notified that the documents are forgeries or that there is fraud in the transaction
- The account party can enjoin the bank from honoring a letter of credit by obtaining a court order (injunction).
- A *force majeure* clause describes events that allow a party to be excused from performing a contractual obligation.

requirement by allowing the demand notice to be made electronically through the SWIFT banking communications network. It should be noted that the standby letter of credit could require the beneficiary party to present additional documents, such as a third-party certification to the nonperformance.

The Federal Reserve of the United States defines standby letter of credit as a letter of credit that "represents an obligation to the beneficiary on the part of the issuer: (1) to repay money borrowed by or advanced to or for the account of the customer (account party); (2) to make payment on account of any evidence of indebtedness undertaken by the account party; or (3) to make payment on account of any default by the account party in the performance of an obligation."⁸ The UCP has traditionally been applied to both documentary credits and standby letters of credit. However, on January 1, 1999, **International Standby Practices (ISP98)** governing standby letters of credit took effect.⁹

Standby letters of credit can be used to help secure a variety of contractual obligations associated with the export transaction. In addition to performance guarantees often associated with construction projects, standby letters have been used to guarantee warranties, to support borrowers under international loans, to ensure availability of suppliers, to secure countertrade commitments, along with acting as deposits in the sale of goods and as prepayment of

fees for services.¹⁰ *Itek Corp. v. First National Bank of Boston* illustrates the use of standby letters of credit to guarantee performance of a construction project and for the return of monies paid by the foreign buyer.

The *Itek Corp. v. First National Bank of Boston* case notes that under the UCC § 5-114(a)(2), a court may enjoin a bank from honoring the demand for payment when the bank has been notified of fraud in the transaction. The “fraud” exception to the traditional reluctance of courts to interfere with commercial letters of credit and guarantees has been liberally construed in the decisional law both before and after the adoption of the Code. However, in most export transactions obtaining an injunction may not be a practical alternative because of the time it takes to obtain such an order.

Alternative Methods of Guaranteeing Performance

Besides the standby letter of credit, there are other methods of guaranteeing a performance or ensuring the return of monies. A **performance bond** minimizes the buyer’s risk of nonperformance by the seller in the export transaction or nonperformance by a contractor in a construction project. The performance bond is a guarantee from an insurance company to pay the insured in case of default (nonperformance). It serves the same function as a standby letter of credit. **Bid bonds** insure against the risk that a bidder may not honor its bid. These are usually required to bid on government procurement contracts.

A **credit surety** guarantees repayment to a bank or lender who finances an export transaction or development project. These sureties generally take the form of a payment guarantee from a state agency, such as **Eximbank**, or from a development bank, such as the **World Bank**. A surety may also be in the form of a corporate guarantee from the parent company. A **retention fund** is not a third-party guarantee, but an arrangement between the principal parties. In large projects or government procurement contracts, a percentage of the monies is deducted from each payment due the supplier or contractor and is retained in a fund pending the completion of the contract or the expiration of a warranty period.

The bank guarantee or **demand guarantee** is a popular means of guaranteeing performance. Like the standby credit, the demand guarantee secures performance of a nonmonetary obligation. It serves as a default device when performance is not satisfactory. Whereas a bank pays a documentary letter of credit only if things go right, a bank will be called upon to pay a demand guarantee or standby letter only if things go wrong. A special concern of demand guarantees is that the lack of rigid documentation requirements allows for the possibility of unfair calls. Often all the beneficiary is required to do is make a written demand for payment.¹¹ Both the ICC and UNCITRAL have developed rules to govern these types of instruments. The ICC has published the **Uniform Rules for Demand Guarantees** (Uniform Rules) and UNCITRAL has released its **Convention on Independent Letters of Guarantee and Standby Credits**. In order to discourage unfair calls on demand guarantees, Article 15 of the Uniform Rules requires the beneficiary to provide a statement describing the way in which the principal is in breach.

Sources of Trade Finance

The ability to finance export transactions is a critical part of most export and import businesses. Financing can be obtained in one of two ways: The first, external to the transaction, is when one of the parties obtains a general loan from a commercial bank or a government agency. The second method, internal to the transaction, is facilitated by two documents found in most export transactions—the bill of lading and the **letter of credit**. The importance of the bill of lading as a document of title was discussed in Chapter 14. A negotiable bill of lading allows for the transfer of the goods while they are in transit. Because it is negotiable, it can be used as collateral to secure a loan.

Exporters naturally want to get paid quickly, and importers usually prefer to delay payment at least until they have received and resold the goods. Because of the intense competition for export markets, being able to offer good payment terms is often necessary to make a sale. Exporters should be aware of the many financing options open to them. In some cases, the exporter may need financing to produce goods that have been ordered or to finance other aspects of a sale, such as promotion and selling expenses, engineering modifications, and shipping costs.

Various financing sources are available to exporters, depending on the specifics of the transaction and the exporter's overall financing needs. A number of variables need to be assessed before making a decision on export or import financing: (1) cost of financing, (2) length of the financing, and (3) risks of financing. The impact on price and profit of different methods of financing should be well understood before a *pro forma invoice* is submitted to the buyer.

The greater the risks associated with the transaction the greater the costs of financing and the more difficult financing will be to obtain. The creditworthiness of the buyer directly affects the probability of payment to the exporter, but it is not the only factor of concern to a potential lender. The political and economic stability of the buyer's country also can be a factor. To provide financing for either accounts receivable or the production or purchase of the product for sale, the lender may require more secure methods of payment, such as a letter of credit or export credit insurance. If a lender is uncertain about the exporter's ability to perform, or if additional credit capacity is needed, a government guarantee program may enable the lender to provide additional financing. The best place to begin, however, is by researching the services provided by commercial banks. Because of their international banking connections and expertise in international business transactions, commercial banks are great sources for information.

Commercial Banks

More than 300 U.S. banks have international banking departments and specialists familiar with specific foreign countries and various types of commodities and transactions. These large banks, located in major U.S. cities, maintain correspondent relationships with smaller banks throughout the country. Larger banks also maintain correspondent relationships with banks in most foreign countries or operate their own overseas branches, providing a direct channel to foreign customers. International banking specialists are generally well informed about export matters. If they are unable to provide direct guidance or assistance, they may be able to refer inquirers to other specialists who can. Banks frequently provide consultation and guidance free of charge to their clients, since they derive income primarily from loans to the exporter and from fees for special services.

Finally, large banks frequently conduct seminars and workshops on letters of credit, documentary collections, and other banking subjects of concern to exporters. Among the many services a commercial bank may perform for its clients are the following: (1) exchange of currencies, (2) assistance in financing exports, (3) collection of foreign invoices, drafts, and letters of credit, (4) transfer of funds to other countries, and (5) credit information on potential representatives or buyers overseas.

A logical first step in obtaining financing is for an exporter to approach its local commercial bank. If the exporter already has a loan for domestic needs, then the lender already has experience with the exporter's ability to perform. Many lenders, therefore, would be willing to provide financing for export transactions if there was a reasonable certainty of repayment. By using letters of credit or export credit insurance, an exporter can reduce the lender's risk. A government guarantee program may offer a lender greater assurance than is afforded by the transaction, enabling the lender to extend credit to the exporter. When selecting a bank, the exporter should ask the following questions: (1) What are the charges for confirming a letter of credit, processing drafts, and collecting payment? (2) Does the bank have foreign branches or correspondent banks? Where are they located? and (3) Does the bank have experience with U.S. and state government financing programs that support small business export transactions?

A time draft under an irrevocable letter of credit, confirmed by a U.S. bank, presents relatively little risk of default. To convert these instruments to cash immediately, an exporter must obtain a loan using the draft as collateral or sell the draft to an investor or a bank for a fee. When the draft is sold to an investor or bank, it is sold at a discount. Banks or other lenders may be willing to buy time drafts that a creditworthy foreign buyer has accepted or agreed to pay at a specified future date. These endorsed drafts or bills of exchange are what were earlier described as trade acceptances.

In some cases, banks pre-agree to accept the obligations of paying a draft, usually of a customer, for a fee. As discussed previously, the banker's acceptance is a draft drawn on and accepted by a bank (see Figure 15.5 *Focus on*

PAY TO ORDER THE TRANSACTION WHICH GIVES RISE TO THIS INSTRUMENT IS THE IMPORT/EXPORT OF CLOTHES FROM: USA TO: FORTUGA FOR VALUE RECEIVED AND ORDER TO ACCOUNT OF CITIBANK		November 26 19__ 120 SIGHT ACCEPTED November 28, 19__ Citibank, N.A. <i>W.W. Smith</i> Authorized Signature	00 312
Citibank, N.A. 111 WALL STREET NEW YORK, NY 10043		<i>Harold Fore</i> Arthur's Clothes for Export Inc.	

Figure 15.5 Focus on Transactions: Banker's Acceptance.

Transactions: "Banker's Acceptance"). Depending on the bank's creditworthiness, the acceptance becomes a financial instrument that can be discounted and sold before maturity. The exporter receives an amount less than the face value of the draft so that when the draft is paid at its face value at the specified future date, the investor or bank receives more than it paid to the exporter. The difference between the amount paid to the exporter and the face amount paid at maturity is called a discount and represents the fees or interest the investor or bank receives for holding the draft until maturity. The bank often discounts drafts **without recourse** to the exporter in case of default by the drawee. Other drafts may be discounted with recourse to the exporter, in which case the exporter must reimburse the investor or bank if the party obligated to pay the draft defaults.

Factoring and Forfaiting

Factoring is the discounting of foreign account receivables without a draft. The exporter transfers title to its account receivables to a factoring company at a discount. These houses specialize in the financing of account receivables by giving cash at a discount from the face value. Although factoring is often done without recourse to the exporter, the exporter should verify the specific arrangement. The factoring company assumes the financial risk of nonpayment and handles the collections on the receivables. Export factoring allows an exporter to sell on **open account**, by which goods are shipped without a guarantee of payment such as a letter of credit.

There are two types of factoring schemes—single factor and two-factor systems. The two-factor system involves the use of two factoring companies: an export factor and import factor. The two-factor method is the most efficient and secure. The exporter hires the export factor, and the export factor contracts with an import factor in the country of import. The import factor is useful in assessing the credit worthiness of the importer. Upon delivery of the goods, the import factor issues an invoice to the importer with a copy sent to the export factor. The export factor will then advance 80 percent of the invoice value to the exporter. The import factor also is responsible for collection from overdue accounts including resorting to legal action. The two-factor system may be a bit more expensive than the single-factor one, but is well worth it depending on the risks presented by the country of importation. Finally, the exporter can negotiate "disguised or undisclosed factoring" in which the importer is not informed that its accounts receivable will be factored. The exporter does not want the buyer to question the financial stability of the exporter's company due to the need to factor.

Forfaiting is the selling at a discount of longer-term account receivables or promissory notes of the foreign buyer. This is a form of supplier credit in which the exporter turns over export receivables, usually guaranteed by a bank in the importer's country, by selling them at a discount to a forfaiter. This arrangement is generally agreed to in advance before the conclusion of the sales contract. The exporter is thus able to incorporate the discount (costs) into the selling price. Forfaiters usually deal in bills of exchange or promissory notes that can be sold on the secondary market. Both U.S. and European forfaiting houses are active in the U.S. market. For a comparison of the different characteristics of factoring and forfaiting, see Table 15.2 *Focus on Transactions: "Comparison: Factoring versus Forfaiting."*

Table 15.2 Focus on Transactions: Comparison: Factoring versus Forfaiting

Characteristics	Factoring	Forfaiting
Types of items used to obtain financing	Low-value, short-term (90–120 days) accounts receivables	Higher-value, medium- to long-term (may exceed 180 days) obligations
Number of instruments or transactions	Numerous and continuous flow of invoices (accounts receivables)	Provides financing for individual transactions
Amount advanced or paid	Generally about 80 percent of the value of the invoices or accounts receivable	Payment given on full invoice price
Type of instruments needed	Unsecured accounts receivable	Requires negotiable instrument such as bank draft (often requires bank guarantee) or promissory note
Rate of discount (fees)	Lower	Higher
Other benefits	Provide risk assessments of prospective buyers and sales accounting services (important for small exporters)	Purchases drafts and notes on a nonrecourse basis; assumes commercial, currency, and political risks

Buyer and Supplier Financing

In order to produce the goods under an export contract, the seller will often need to obtain financing. This financing will at times come from the buyer or from the seller's suppliers. One form of buyer financing is when a letter of credit allows for progress payments. Under a progress payment, the bank is authorized by the buyer to pay seller on inspection by the buyer's agent or receipt of a statement by the seller that a certain percentage of the product has been completed. This type of partial payment under a letter of credit is known as a **red clause** advance. Under the red clause, the seller may demand a partial payment under the letter of credit before the presentation of documents. It is called a red clause because of the danger associated with it. The buyer is at risk for any red clause payments. If the seller subsequently fails to produce the goods or provide conforming documents, then the buyer must reimburse the bank for any red clause advances. Red clause payments are simply unsecured loans from the buyer to the seller.

Supplier financing is generally obtained through the supplier's selling materials to the exporter on account. Generally the seller produces the goods needed to fulfill the export contract and pays its suppliers before the due date out of the proceeds from the export contract. Suppliers will want some sort of collateral or security for selling materials on account, however. Two methods of providing such security are the **transferable credit** and the **back-to-back letter of credit** (see Figure 15.6 Focus on Transactions: "Back-to-Back Letter of Credit").

Under the transferable credit arrangement, suppliers accept assignment of a part of the letter of credit that the seller receives from the buyer in the export transaction. If agreeable to the bank a documentary letter of credit can be

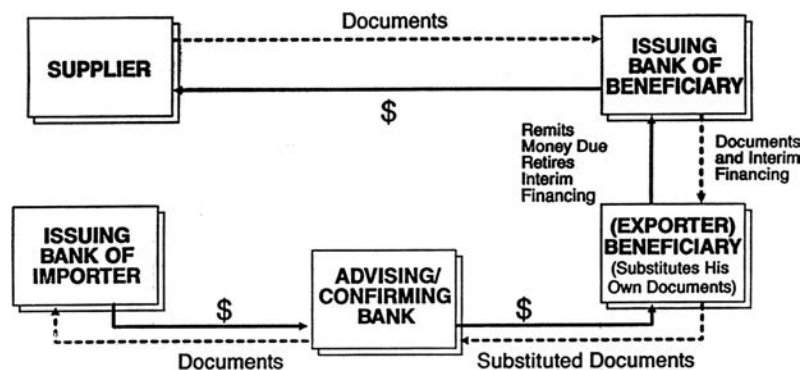


Figure 15.6 Focus on Transactions: Back-to-Back Letter of Credit.

Table 15.3 *Doing Business Internationally*: Features and Risks of Different Types of Drafts and Credits

Type	Time of Payment	Goods Available	Risk to Exporter	Risk to Importer
Irrevocable	At sight (confirming bank)	After payment	Provides most security	Fraud in the transaction
Revocable	At sight	After payment	Provides least security	Easier for issuing bank to cancel in cases of fraud
Sight Draft	Soon after shipment of goods	After payment	Risk on confirming bank	Assured shipment has been made
Time Draft	At maturity of draft	Before payment	Loses control over goods	Assured delivery before payment
Red Clause	Percentage of payment before shipment	After payment	Confirming and issuing banks	Total risk on amount paid in advance
Transferable	At sight	After payment	Payment to creditor or supplier	None
Back-to-Back	At sight	After payment	Payment to secondary beneficiaries	None
Standby L/C	At sight	After payment	Payment to importer for nonperformance	None

Government-Guaranteed Export Working Capital Programs: The U.S. Small Business Administration and the U.S. Exim-bank offer programs that guarantee export working capital facilities granted by participating lenders to U.S. exporters. With those programs, U.S. exporters can obtain needed funding from commercial lenders when financing is otherwise not available.

Export Credit Insurance: Export credit insurance provides protection against commercial losses, such as default, insolvency, bankruptcy of the buyer, and political losses due to events, such as war, nationalization, and currency inconvertibility. It allows exporters to increase sales by offering more liberal open account terms to new and existing customers. Insurance also provides security for banks that are providing working capital and are financing exports.

Export Factoring: Factoring in international trade is the discounting of short-term receivables (up to 180 days). The exporter transfers title to his short-term foreign accounts receivable to a factoring house, or a factor, for cash at a discount from the face value. It allows an exporter to ship on open account as the factor assumes the financial liability of the importer to pay and handles collections on the receivables. Factors usually work with exports of consumer goods.

Forfaiting: Forfaiting is a method of trade financing that allows the exporter to sell his medium and long-term receivables (180 days to seven years or more) to a forfaiter at a discount, in exchange for cash. The forfaiter assumes all the risks, thereby enabling the exporter to offer extended credit terms and to incorporate the discount into the selling price. Forfaiters usually work with exports of capital goods, commodities, and large projects.

Figure 15.7 *Focus on Transactions*: Competing Internationally by Offering Open Account Terms.

made expressly transferable. It can then be divided and transferred to numerous suppliers of the exporter in order to guarantee payment to them upon the payment of the underlying letter of credit. Otherwise, some banks allow only a single transfer or assignment of a letter of credit.

The seller arranges the back-to-back letter of credit without the assistance of the buyer or issuing bank. The seller makes arrangements with a third-party bank to take the letter of credit from the export transaction as collateral for a new letter of credit. The third-party bank in partial amounts issues a new letter of credit to the suppliers of the seller. Thus, unlike the transferable credit arrangement, the back-to-back letter of credit scenario involves two separate letters of credit. The documentary letter of credit simply acts as collateral for the second letter of credit. The back-to-back letter of credit highlights the importance of the documentary letter of credit in both guaranteeing payments and in financing international trade. Table 15.3 *Doing Business Internationally*: “Features and Risks of Different Types of Drafts and Credits” compares the risks of the exporter–seller and importer–buyer in the use of different types of drafts and letters of credit.

In order to compete internationally, the exporter may have to sell on open account, which like a time draft provides additional time for the buyer to make payment after receiving the goods. The problem is that the exporter may not have the financial ability to wait for payment. In order to provide open account terms, such exporters will need to obtain funding in order to overcome cash flow problems that an open account sale may cause. Figure 15.7 *Focus on Transactions*: “Competing Internationally by Offering Open Account Terms” provides a number of options available to the American exporter.

Government Assistance Programs

Several U.S. government agencies, as well as a number of state and local ones, offer programs to assist exporters with their financing needs. Some are guarantee programs that require the participation of an approved lender; others provide loans or grants to the exporter or a foreign government. Government guarantee and insurance programs are used by commercial banks to reduce the risk associated with loans to exporters. The **Eximbank** is the U.S. government’s general trade finance agency, offering numerous programs to address a broad range of export needs. Exim’s loan guarantees support U.S. exporters in securing competitive financing for creditworthy international buyers. Eximbank’s insurance policies cover: (1) commercial risk relating to the buyer becoming insolvent or bankrupt, or there is a prolonged default in payment; (2) political risks including actions taken by a government, such as, war, hostilities, cancellation of licenses, or inconvertibility of currency; and (3) special policies for small businesses that offer up to 95 percent coverage against nonpayment by foreign buyers on short-term credit sales.

Eximbank offers four major export finance programs, including loans, guarantees, working capital guarantees, and insurance. It provides these services to U.S. exporters and foreign buyers. Eximbank’s insurance and guarantee programs are structured to encourage private financial institutions to fund U.S. exports by reducing the commercial risks of nonpayment and political risks, such as war and currency inconvertibility. Eximbank’s Working Capital Loan Guarantee Program provides guarantees to private banks that allow American businesses to obtain standby letters of credit necessary to compete internationally. Eximbank’s guarantees also help secure competitive financing that can be used to attract international buyers. It also provides financing for up to ten years to creditworthy international buyers. The case study in Figure 15.8 shows how these programs can assist American businesses. Eximbank also offers a Finance Lease Guarantee Program that provides lease financing to creditworthy international buyers as an alternative to traditional installment loans that would have to be provided by the American exporter or a financial institution.

Eximbank’s affiliate, the **Foreign Corporation Insurance Agency (FCIA)**, offers credit insurance that protects against default on exports sold under open account, drafts, and letters of credit. FCIA’s policies cover up to 100 percent of loss due to specified political risks, such as war and expropriation, and up to 95 percent of loss due to other commercial risks, such as buyer default and insolvency.

The **Overseas Private Insurance Corporation (OPIC)** provides specialized assistance to U.S. firms through its performance bond and contractor insurance programs. OPIC facilitates U.S. foreign direct investment in developing nations and Eastern Europe. An independent, financially self-supporting corporation fully owned by the U.S. government, OPIC encourages U.S. investment projects overseas by offering political risk insurance, guarantees, and direct loans. OPIC political risk insurance protects U.S. investment ventures abroad against the risks of civil strife and other violence, expropriation, and inconvertibility of currency. In addition, OPIC can cover business income loss due to political violence or expropriation.

The **Small Business Administration (SBA)** provides an export **revolving line of credit**. This line of credit guarantees loans to U.S. exporters to help bridge the capital gap between the time inventory and production costs are incurred and the time payment is received from a foreign buyer. The credit line is granted based upon the likelihood of a company completing its export transactions, and the SBA guarantees 85 percent of the credit line. The guarantee covers against default by the exporter; failure on the buyer’s side is expected to be covered by letters of credit or export credit insurance. SBA Export Express program offers financing of up to \$500,000. It is the simplest export loan product offered by the SBA and allows participating lenders to use their own forms and

ABC Supply Inc. is an Oklahoma-based supplier of oilfield equipment, whose primary customers are foreign state-owned enterprises in lesser-developed countries. Foreign contracts are awarded through a public bidding system, which requires businesses to secure a *bid bond* from their lender with every bid and, if they win a contract, a *performance bond* must be provided immediately. Such bonds require exporters to put cash up front as security, which is detrimental to their cash flow.

In order to avoid tying up their working capital (cash), ABC Supply obtained an Eximbank guarantee to access working capital financing from their commercial lender. An Eximbank working capital guarantee ensures that Eximbank will cover 90 percent of the commercial bank's exposure.

By using an Eximbank working capital guarantee, ABC Supply has been able to improve their cash flow, which has permitted it to bid for more business and bigger deals, without the fear of not being able to pay for bid and performance bonds.

Figure 15.8 *Doing Business Internationally*: Case Study: Eximbank Working Capital Guarantee.

procedures. The SBA determines eligibility and provides a loan approval in 36 hours or less. The SBA Export Working Capital Loan program provides advances for up to \$5 million to fund export transactions from purchase orders to collections. This loan has a low guaranty fee and has a quick processing time. Finally, the SBA offers the International Trade Loan Program to U.S. businesses that are preparing to engage in or are already engaged in international trade, or are adversely affected by competition from imports with up to \$5 million in financing to upgrade equipment and facilities.

Chapter Summary

- 1 The letter of credit that calls for payment upon the delivery of the documents is called a Cash Against Document transaction and requires a sight draft. The type of transaction that allows the buyer to obtain the documents and make payment in the future is called Acceptance Against Documents and requires a time draft.
- 2 The buyer obtains a letter of credit from a bank to guarantee payment to the seller. The buyer is called the account party, the seller is the beneficiary, and the bank is referred to as the issuing bank. If the letter of credit is also guaranteed by the seller's bank the letter is referred to as a confirmed letter of credit. If there is no second guarantor, then the seller's bank is simply acting as an advising bank.
- 3 The rules that govern international documentary letters of credit are called the Uniform Customs and Practices for Documentary Credits or UCP 600.
- 4 The UCP rules state that banks are only required to review the documents listed in the letter of credit (facial compliance rule) and are not required to understand the technical terms used by the contracting parties. Other UCP rules presume that letters of credit are not transferrable unless they state so and that they are irrevocable unless they state otherwise.
- 5 The banks are entitled to reject any document that contains a discrepancy under the strict compliance rule. The arbitrariness of banks rejecting generally conforming documents is regulated by the International Standard Banking Practice (ISBP).
- 6 The letter of credit is required to expressly state an expiration date. Despite the express expiration date, an implied second expiration date known as the 21-day rule requires the seller to deliver the documents within 21 days after receiving the bill of lading.
- 7 One form of trade finance is the banker's acceptance in which the issuing or conforming bank guarantees payment by placing a stamp on the time draft. The time draft is then referred to as a banker's acceptance and can be sold on the secondary market.
- 8 The seller's performance may be guaranteed by a standby letter of credit, bank guaranty, or a performance bond. A set of rules that govern standby letters of credit is the International Standby Practices (ISP98).
- 9 Other means of trade financing include back-to-back letters of credit, factoring, and forfaiting. Factoring is the discounting and selling of foreign account receivables to another company. Forfaiting is the selling at a discount of longer-term account receivables or promissory notes. A buyer may also allow an unsecured advance to the seller on the letter of credit through the insertion of a red clause into the letter of credit.

- 10 American companies can also obtain loans, loan guarantees, and insurance through different U.S. agencies and programs. The Eximbank has Working Capital Loan Guarantee and Finance Lease Guarantee programs. The Foreign Corporation Insurance Agency (FCIA) provides credit insurance and the Overseas Private Insurance Corporation (OPIC) has a performance bond program and issues political risk insurance. The Small Business Administration (SBA) provides loans and loan guarantees.

Key Terms

21-Day Rule	Draft	Retention Fund
Acceptance	Eximbank	Revolving Letter of Credit
Account Party	Facial Compliance Rule	Revolving Line of Credit
Advising Bank	Factoring	Rule of Strict Compliance
Back-to-Back Letter of Credit	Foreign Corporation Insurance Agency (FCIA)	Sight Draft
Banker's Acceptance	Forfaiting	Small Business Administration (SBA)
Beneficiary Party	Freight Forwarder	Standby Letter of Credit
Bid Bond	International Standby Practices (ISP98)	Time Draft
Bill of Exchange	Irrevocable Letter of Credit	Trade Acceptance
Bitcoin	Issuing Bank	Transferable Credit
Confirming Bank	Letter of Credit	UCP 600
Convention on Independent Credits	Open Account	Uniform Law on Bills of Exchange
Credit Surety	Overseas Private Insurance Corporation (OPIC)	Uniform Rules for Demand Guarantees
Customs Broker	Performance Bond	Virtual Currency
Demand Guarantee	Power of Attorney	Without Recourse
Documentary Collections Transaction	<i>Pro Forma</i> Invoice	World Bank
Documentary Credit Transaction	Red Clause	

Chapter Problems

- One topic of great interest at a recent global banking conference was dealing with letters of credit in China. As those who use Chinese letters of credit know, the Chinese will reject a letter of credit on the minutest of discrepancies. Several participants now report that in certain instances the scrutiny has gotten even worse. One member related an instance where a letter of credit was rejected because it was signed in blue ink instead of black. Several members theorized that the reason for the increased inspection is the cash flow problems in certain provinces. What can be done to overcome this problem of overly strict review and enforcement of documentary requirements?
- Should the parties to a documentary credit include a dispute resolution clause in their letters of credit or allow disputes to be resolved through litigation? Are there any alternatives to arbitration that could be used to minimize the time and cost of litigation or arbitration?
- A company engaging in the manufacture and sale of telecommunications equipment entered into an agreement with the "Imperial Government of Carpathia" to install and maintain certain telecommunications equipment. As a condition of the contract and to secure the advance payment, the company was required to guarantee its performance by obtaining two irrevocable letters of credit in the amounts equal to the advance payments made by Carpathia. Subsequently, a revolution occurred in Carpathia and the company was at least temporarily prevented from finishing the

contract. The company was concerned that a new government would “arbitrarily” demand payment on the letters of credit. In light of the foregoing, the company sought a preliminary injunction preventing the bank from making payment on the letters of credit without first giving the company an opportunity to prove lack of authenticity or the fraudulent nature of the demand. Should the court grant a preliminary injunction? *Stromberg-Carlson Corp. v. Bank Melli Iran*, 467 F. Supp. 530 (SDNY 1979).

- 4 The terms and conditions of a letter of credit state that the beneficiary party (seller) is to provide a certificate of origin listing the goods as originating from “NAFTA Countries.” The certificate of origin did state “NAFTA Countries,” but the commercial invoice stated only “NAFTA.” The issuing bank rejected the documents because the declaration of origin in the commercial invoice was inconsistent with the declaration in the certificate of origin. The beneficiary party bank sues the issuing bank for wrongfully dishonoring the letter of credit. Under the UCP, who wins? Why?
- 5 A letter of credit is issued with the following terms and conditions: “(1) The beneficiary party must present a full set of clean-on-board bills of lading evidencing shipment from Port A to Port B and (2) documents must arrive at the offices of the issuing bank before arrival of the ship at Port B.” The issuing bank rejected the documents for the following reasons: “(1) The bill of lading does not indicate that the goods were placed on board, but instead states that they were taken in charge at Container Freight Yard and (2) the documents were untimely because they were presented to the bank one day after the arrival of the ship.” Were the two discrepancies given appropriate for rejecting the documents?
- 6 Test your knowledge of trade finance terminology. Match the term with its definition (see answers on the next page).

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- | | |
|-----------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------|
| (A) Irrevocable | (1) A letter of credit that does not require the presentation of specified documents. It is extremely risky for the purchaser in an export transaction. |
| (B) Negotiable | (2) The letter of credit used in an export transaction that requires the seller to present specified documents in order to receive payment under the letter. |
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|------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| (C) Transferable | (3) A draft or bill of exchange that requires the bank to pay under the letter of credit at the time the documents are presented. |
| (D) Confirmed | (4) A letter of credit in which the buyer is named as beneficiary.
It is used to guarantee performance on a contract and the return of a deposit or installment payments. |
| (E) Clean | (5) Cannot be revoked without beneficiary's consent. Most common form used in international transactions because it provides greatest security against nonpayment. |
| (F) Revolving | (6) The provision in a letter of credit allows for the advancement of monies prior to the seller presenting the required documents. This is a means by which a buyer can provide financing to the seller. It is very risky because it is unsecured and the buyer is responsible to reimburse the bank whether the seller performs or not. |
| (G) Documentary Credit | (7) Permits the accompanying drafts or bills of exchange to be transferred. This allows for the negotiation of a draft at other banks. The issuing bank is required to reimburse any bank that negotiates the letter of credit. |
| (H) Standby | (8) A second bank endorses the letter of credit indicating that it will also guarantee payment upon the presentation of the required documents. In an export transaction, the exporter's bank will generally be that bank. |
| (I) Sight Bill | (9) Permits the beneficiary to negotiate the letter of credit to secondary beneficiaries. The original letter of credit must expressly state that it is transferable. |
| (J) Time Bill | (10) The buyer provides the seller with a letter of credit. That credit is used as collateral to obtain a second letter of credit by the seller. The second provides a guarantee to the seller's suppliers. The second letter finances the acquisition of the materials needed by the seller to produce the goods. |
| (K) Red Clause | (11) Generally granted by commercial banks to large importers. The buyer is allowed to reuse the credit after the bank is reimbursed. |
| (L) Back-to-Back | (12) A draft or bill of exchange that orders the bank to pay on the letter of credit only after passage of a certain amount of time after the presentation of the documents. This allows the buyer to resell the goods or to obtain financing before being required to pay the seller. |
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Internet Exercises

- 1 Research the availability and requirements of the Small Business Administration's Trade Finance Program.
- 2 Take a self-guided tour from a Canadian perspective of an international trade transaction at www.royalbank.com/trade.
- 3 The U.S. Eximbank is America's largest export financing agency. Explore www.exim.gov to see how its programs benefit U.S. exporters.

Other Internet Sources

Dictionary of **banking terms**: www.helpwithmybank.gov/dictionary.

Example of **Draft Transmittal Letter**: www.unzco.com/basicguide/figure12.html. Click on "Figure 12."

World Bank—links to Multilateral Investment Guarantee Agency (MIGA), International Development Association (IDA), and International Finance Corporation (IFC): www.worldbank.org.

[Answers to Problem 6: A(5); B(7); C(9); D(8); E(1); F(11); G(2); H(4); I(3); J(12); K(6); L(10).]

Notes

- 1 The SWIFT network, cooperatively owned by more than 1,000 banks, was set up to provide banks with a means of handling interbank transactions, including bank transfers and foreign exchange confirmations.
- 2 The terms *draft* and *bill of exchange* can be used interchangeably. The term used in the United Kingdom is *bill of exchange*. The term used in the United States is *draft*.
- 3 112 K.B. 37 (1943).
- 4 UCC § Section 5-112.
- 5 554 N.Y.S.2d 757 (1990).
- 6 www.swift.com.
- 7 Lawrence Trautman, "Virtual Currencies & Bitcoin; What Now After Liberty Reserve, Silk Road, and Mt. Gox?," 20-4 *Richmond Journal of Law and Technology* 13 (2014).
- 8 Regulation H, 12 C.F.R. § 208.8(d)(1) (1979).
- 9 The ISP98 can be obtained through the web site of the Institute of International Banking Law and Practice at <http://iiblp.org/resources/isp98>.
- 10 See Gordon Graham and Benjamin Geva, "Standby Credits in Canada," 9 *Canadian Business Law Journal* 180 (1982).
- 11 Roy Goode, "Abstract Payment Undertakings in International Transactions," 22 *Brooklyn Journal of International Law* 1, 15 (1996).

EMPLOYMENT AND SALE OF SERVICES

Traditionally, international business law courses have focused on the sale of goods rather than the sale of services. This chapter is intended to alert the student to the importance of sales of services in international trade. A growing portion of U.S. and world exports falls in the areas of sale of services and the licensing of technology. This chapter will highlight the former; Chapters 18 and 19 will review the latter. Due to the breadth of the topic, this chapter is formatted somewhat differently than the other chapters in the book. Instead of providing cases for illustrative and pedagogical purposes, the coverage is more descriptive. The focus is on the practical issues that an individual or company faces in hiring foreign personnel. It includes an extensive review of the legalities associated with hiring foreign employees, with a focus on European employment law. The chapter also discusses the importance of independent contractor status, but leaves a more in-depth analysis to Chapter's 17's coverage related to contracting with foreign agents and distributors, who are commonly viewed as independent contractors.

Exporting of Services

The United States is the world's premier producer and exporter of services. As the largest component of the U.S. economy, the service sector includes all private-sector economic activity other than agriculture, mining, construction, and manufacturing. The service sector accounts for 90 million jobs, which is nearly 80 percent of the private-sector gross domestic product (GDP).

In the future, the service sector is expected to grow as a percentage of the U.S. economy. Small and medium-sized entrepreneurial companies—those employing fewer than 500 employees—overwhelmingly lead this service-driven business expansion. More than 4 million small U.S. service companies account for more than 16 million jobs. Although small service companies make up most of the service sector, many of the most prominent U.S. service exporters are large companies.

The dominant role that services play throughout the U.S. economy translates into leadership in technology advancement, as well as growth in skilled jobs and global competitiveness. U.S. service exports more than doubled between 1990 and 2000—increasing from \$148 billion in 1990 to \$299 billion in 2000. Growth continued to \$404 billion in 2006, \$632 billion in 2012, and \$682 billion in 2013. Major markets for U.S. services include the European Union (US), Japan, and Canada. Mexico is the largest emerging market for U.S. service exports.¹ See Table 16.1 *Doing Business Internationally*: “U.S. Service Exports.”

The globalization of services is similar to global supply chains in the production of goods. The coordination of business functions across national borders. Types of services outsourced by U.S. companies include: technical and business services such as IT, software development, accounting, legal, human resources, engineering, and customer services (contact centers), as well as research and development. U.S. companies outsource most to Asian countries (69 percent), with 47 percent of all American outsourcing being to the country of India. Other major areas for American outsourcing include: China (10 percent), Southeast Asia (10 percent), Central America (8 percent), Eastern Europe (6 percent), and Western Europe (6 percent).

In 2014, world services exports rose by 4.2 percent to 4.9 trillion dollars. Transport services grew by 2.5 percent, while travel services and goods-related services increased by 3.9 percent and 2.8 percent respectively, from the

previous year. Between 2009 and 2014, **Less Developed Countries (LDCs)** experienced the highest growth rate at 13.5 percent, followed by developing Asia (9.5 percent) and developing America (8.1 percent). In LDCs, as in a majority of regions, travel and transport accounted for a large part of services exports. Figure 16.1 *Doing Business Internationally*: “Annual Growth Rates in the Export of Goods and Services” shows the annual growth rates in the export of goods and services from 2009–2014.

Sales of services are generally effectuated through employment and **consulting contracts**, which would seem to indicate that these transactions are purely private in nature. This is generally true in a domestic sale of services contract in the United States, but a host of restrictions and regulations are imposed on the international sale of services. Unlike the United States, some countries have developed an entire regulatory scheme that covers such transactions. This chapter provides examples of foreign regulations that the international employer, principal, agent, consultant, and employee will need to become accustomed with.

Table 16.1 *Doing Business Internationally*: U.S. Service Exports (Billions of Dollars)

Country	2011	2012	2013	2014*
Canada	58.3	61.5	63.3	47.2
United Kingdom	57.3	59.2	60.3	56.7
Japan	48.8	46.5	46.3	35.1
China	28.4	33.1	37.8	31.1
Mexico	26.4	28.2	29.9	22.3
Germany	27.1	27	27.5	21.1
Brazil	23.3	25	26.6	21
South Korea	16.7	18	20.9	15.6
France	18.7	17.9	19.5	15.5
India	11.8	12.35	13.5	10.7
Italy	9.2	8.7	9.35	7.4
Saudi Arabia	6.5	7.9	9.2	6.8
Other Countries	300.3	309.4	323.35	280.4

* Through September 2014 (three quarters).

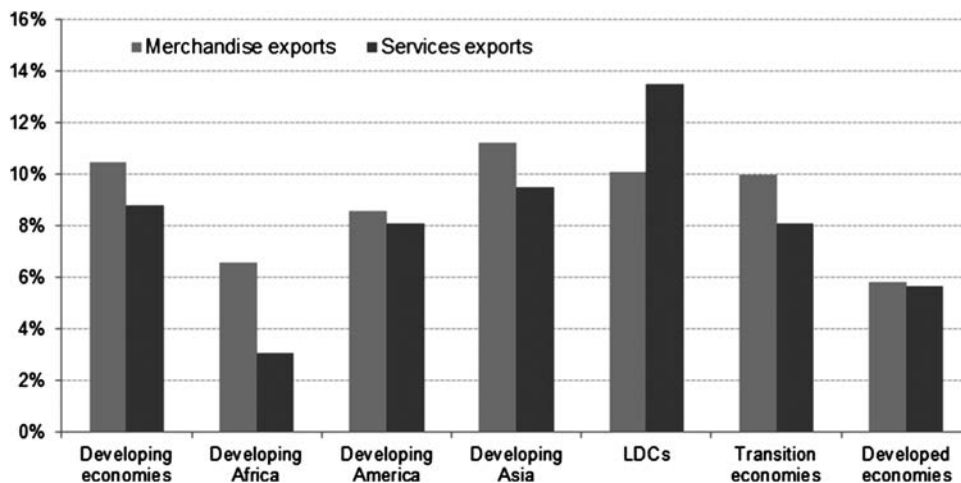


Figure 16.1 *Doing Business Internationally*: Annual Growth Rates in the Export of Goods and Services (2009–2014).

This chapter will review the generic ways people sell services—namely the employment, foreign sales representation, and commercial agency contracts. The distinction between employment and independent contracting is examined in conjunction with these three ways of selling services. This material can be applied to sales of services in any type of industry and business. As was apparent through the earlier chapters of this book, a number of service industries make the sale of goods transaction possible. This chapter concludes with a review of some specific service areas including logistics, advertising, security offerings, and accounting.

Service contracts exist in almost all industries and businesses. An exact definition of sale of services is difficult to fashion because services comprise a broad range of activities. One way of defining a sale of services is by comparing it to the other two modes of international trade—sale of goods and licensing. A good is something tangible and movable. Sale of goods transactions include the sale of raw materials, component parts, equipment, and consumer products. Licensing involves a less than total transfer of ownership found in the sale transaction. Licenses generally pertain to intangible items such as technology, know-how, trade secrets, and intellectual property rights (trademarks, patents, copyrights). As discussed in Chapter 8, many transactions are **mixed sales** that include two or all three of the above modes of doing business (sale of goods, license, sale of services). A technology transfer, for example, may include a sale of goods (software or computer equipment), a license (right to use the software), and a sale of services (technical assistance and training).

International Sale of Services

The **Organisation for Economic Co-operation and Development (OECD)** has estimated that between 60 percent and 70 percent of the business sector in OECD countries² relates to the sale of services. The principal markets for U.S. services—Canada, Japan, and the EU—have been growing at a 10 to 15 percent annual rate. Export growth for services exists in Latin America, Asia, and Central and Eastern Europe. The means for selling services internationally include international consulting, services related to the export of goods, electronic transfers of knowledge and data, licensing agreements, franchising services, and tourism services. There has been rapid growth in many service sectors, including transport, communications, finance, and business services, along with knowledge-intensive services, such as computing and consultant services. Advances in innovation, information, knowledge, and communications technologies have driven increased productivity in all segments of business. The United States has become a major international exporter of these types of knowledge and information-based services.

The rules-based multilateral trading system so successful in reducing barriers to trade in goods is now being expanded in the area of trade in services. A number of WTO Agreements, starting with the **General Agreement on Trade in Services (GATS)**, concluded during the Uruguay Round of GATT, are targeted to reducing obstacles to trade in services. At the bilateral level, the United States and the EU reached a number of **Mutual Recognition Agreements (MRAs)**. These agreements are aimed at reducing trade barriers in specific industries. Trade barrier reduction is to be achieved through the mutual recognition of each other's product testing and certification procedures. At the nongovernmental level, the **Trans-Atlantic Business Dialogue (TABD)** "endorsed bilateral and multilateral cooperation in the area of electronic commerce and identified five priority issues: protection of personal data and privacy; digital signatures and harmonized legal framework; encryption; tax, tariff, and customs; and intellectual property, protection, and associated liabilities."³

Service industries span a wide variety of enterprises from hamburgers to high technology. The service sector accounts for about 70 percent of the U.S. Gross National Product (GNP) and 75 percent of employment. Internationally, a similar change has taken place. World trade in services grew in the past decade at an average rate of 5 percent a year to constitute approximately 20 percent of overall world trade. The leading exporter of services is the United States. Eighteen percent of all its exports are for services.

In view of the shift toward services both domestically and internationally and the substantial competitive advantage of the United States in the services field, liberalization in the trade for services has become an important U.S. policy objective. This is evidenced by the fact that the United States was a major promoter of GATS. Most business services can be exported, especially the highly innovative, specialized, or technologically advanced

services that are efficiently performed in the United States. The following sectors have particularly high export potential for U.S. service providers: (1) construction, design, and engineering, (2) banking and financial services, (3) insurance services, (4) legal and accounting services, (5) computer and data services, (6) teaching services, and (7) management consulting services. Figure 16.2 *Doing Business Internationally*: “U.S. Service Exports with High Growth Potential” lists some of the longstanding and new areas of service exports.

There are a number of important features that differentiate exporting services from exporting products. First, services are less tangible than products, providing little in terms of samples that can be seen by the potential foreign buyer. Consequently, communicating a service offer is much more difficult than communicating a product offer. Second, the intangibility of services makes financing more difficult. Financial institutions are less willing to provide financial support for service exports than for product exports. Third, selling services is more personal than selling products, because it quite often requires direct involvement with the customer. This involvement demands greater cultural sensitivity. Fourth, services are much more difficult to standardize than products. Service activities must frequently be tailored to the specific needs of the buyer. This need for adaptation often necessitates the service client’s direct participation and cooperation in the service delivery.

Demand for certain services is often related to product exports. Many merchandise exports from the United States would not take place if they were not supported by service activities such as banking, insurance, and

<p style="text-align: center;"><u>Travel and Tourism</u></p> <p>The largest single category within the U.S. service sector encompasses travel-and tourism-related businesses, including recreational and cultural services. The industry is diverse and encompasses services in transportation, lodging, food and beverage, recreation, and purchase of incidentals consumed while in transit.</p> <p style="text-align: center;"><u>Environmental Services</u></p> <p>The environmental technologies industry incorporates all goods and services that generate revenue associated with environmental protection, assessment, compliance with environmental regulations, pollution control, waste management, remediation of contaminated property, design and operation of environmental infrastructure, and provision and delivery of environmental resources. The U.S. is the largest producer and consumer of environmental technologies in the world.</p> <p style="text-align: center;"><u>Transportation Services</u></p> <p>This sector encompasses aviation, ocean shipping, inland waterways, railroads, trucking, pipelines, and intermodal services, as well as ancillary and support services in ports, airports, rail yards, and truck terminals. Transportation is the indispensable service for international trade in goods, moving all manufactured, mining, and agricultural products to market as well as transporting people engaged in business, travel, and tourism.</p> <p style="text-align: center;"><u>Banking, Financial, and Insurance Services</u></p> <p>U.S. financial institutions are very competitive internationally in areas such as account management, credit card operations, and collection management. U.S. insurers offer valuable services, ranging from underwriting and risk evaluation to insurance operations and management contracts in the international marketplace.</p>	<p style="text-align: center;"><u>Telecommunications and Information Services</u></p> <p>Electronic commerce activities include e-mail, funds transfer, and data interchange, as well as data processing, network services, electronic information services, and professional computer services. The U.S. leads the world in marketing new technologies and enjoys a competitive advantage in computer operations, data processing and transmission, online services, computer consulting, and systems integration.</p> <p style="text-align: center;"><u>Education and Training Services</u></p> <p>Management training, technical training, and English language training are areas in which U.S. expertise remains unchallenged. The export market for such training is growing and encompasses most industry sectors for products and services.</p> <p style="text-align: center;"><u>Commercial, Professional, and Technical Services</u></p> <p>This sector comprises accounting, advertising, and legal and management consulting services. The international market for those services is expanding at a more rapid rate than the U.S. domestic market. Organizations and business enterprises all over the world look to U.S. companies as leaders in these sectors.</p> <p style="text-align: center;"><u>Entertainment</u></p> <p>The U.S. film and music industries have been very successful in appealing to audiences worldwide. U.S. film companies license and sell rights to exhibit films in movie theaters, on television, on videocassettes, and on DVDs and CDs.</p> <p style="text-align: center;"><u>Architectural, Construction, and Engineering Services</u></p> <p>The vast experience and technological leadership of the U.S. construction industry, as well as special skills in operations, maintenance, and management, give U.S. companies a competitive advantage in international projects. This expertise has been recognized in specialized fields, such as electric-power utilities, construction, bioremediation, and engineering services.</p>
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Figure 16.2 *Doing Business Internationally*: U.S. Service Exports with High Growth Potential.

transportation. For example, the big accounting firms have expanded into the customs compliance area. Spurred by globalization and stricter compliance by U.S. Customs, the accounting firms now offer specialized services to help companies comply with Customs regulations. Since enactment of the **Customs Modernization Act of 1993**, importers and exporters are required to submit to periodic customs audits and to comply with strict record-keeping requirements. The accounting firms have expanded their services to include advising exporters and importers on how to minimize payment of duties and value-added tax, as well as on handling transfer-pricing and international tax issues. They also offer consulting in valuation, sourcing, trade strategies, logistics, trade process management, and information technology.

In recognition of the increasing importance of service exports, the U.S. Department of Commerce has made the **Office of Service Industries** responsible for analyzing and promoting the services trade. The Office of Service Industries provides information on opportunities and operations of services abroad. A number of its divisions focus on specific industry sectors including information, transportation, tourism, marketing, finance, and management.

General Agreement on Trade in Services (GATS)

The WTO GATS is a **Framework Agreement** containing basic obligations which apply to all member countries. For a long time most of the services sector in countries was almost completely staffed by nationals of a country. Some countries still mandate that only nationals may act as agents and in others commercial agents must be registered with the government. For example, a lawyer, architect, doctor, and so forth from one country cannot practice their services in another country without having to be retrained or recertified. The EU has made some inroads for allowing people certified in one EU country to practice their profession in other EU countries without needing to pursue additional education or training. In recent decades, the rise of the e-service sector has challenged the national barriers to trade in services. Numerous countries have adjusted their regulations to accommodate transborder e-services including e-banking, distance learning, software development, consultant services, and collaborative works.

While national governments have the option to exclude any specific government services from liberalization under GATS, they are also under pressure from international business interests to refrain from excluding any service “provided on a commercial basis.” Since public utilities, such as those that provide water and electricity, most commonly involve purchases by consumers they can be plausibly characterized as commercial in nature. This definition defines virtually any public service as being “provided on a commercial basis” and is already extending into such areas as police, the military, prisons, the justice system, public administration, and government. Over a fairly short time perspective, this could open up for the privatization of large parts of what today are considered public services currently available for the whole population of a country as a social entitlement, to be restructured, contracted out to for-profit providers, and eventually fully privatized and available only to those who can pay for them. This process is currently far advanced in most countries, usually (and intentionally) without properly informing or consulting the public as to whether or not this is what they desire.

The preamble in the GATS agreement places the liberalization of trade in services as necessary to promote economic growth, especially in developing countries. It is a means of helping impoverished and developing countries by allowing them access to services that may not be available in their countries.⁴ The two main principles of GATS are to increase transparency and the liberalization of international trade in services. The first principle encourages countries to write and make available clear and stable rules and regulations for foreign parties who want to provide services in the country. The second principle, liberalization, refers to the reducing of obstacles to trade in services. One way would be for countries to reciprocally recognize degrees, licenses, and certifications of service professionals in each other’s country. An alternative method would be the harmonization of standards and requirements regionally and internationally. Some such harmonization has happened within NAFTA and the EU.

Why is GATS or some international mechanism needed? Some reasons include the general growth in services as a percentage of GDP and as an export. This is due to a number of factors including technological advancement and the commercialization of services as countries have privatized their national industries. Another reason for reducing barriers to trade in services is the growing importance and internationalization of financial, transport, and telecommunication services. The free flow of services supports growth in general and facilitates foreign direct investment. It also allows companies and individuals to achieve economies of scale that they would not be able to obtain at the local level.

Part II of GATS sets out general obligations and disciplines. A **most-favored-nation** obligation states that each party “shall accord immediately and unconditionally to services and service providers of any other member country, treatment no less favorable than that it accords to like services and service providers of any other country.”

Transparency requirements include publication of all relevant laws and regulations pertaining to the providing of services by foreign individuals or companies. Since domestic regulations and not cross-border rules provide the most significant influence on services trade, provisions spell out that all such measures of general application should be administered in a reasonable, objective, and impartial manner. The Agreement contains obligations with respect to **recognition requirements** for the purpose of securing authorizations, licenses, or certification to provide a service. These types of requirements pertain mostly to professional trades including legal, engineering, medical, insurance, and accounting.

Part III contains provisions on market access and **national treatment** as listed in national schedules. For example, national restrictions on the kind of legal entity or joint venture through which a service is provided or any foreign capital limitations must be eliminated. The national-treatment provision contains the obligation to treat foreign services suppliers and domestic services suppliers in the same manner. Part IV of the Agreement establishes the basis for progressive liberalization in the services area through successive rounds of negotiations and the development of national schedules. Part V of the Agreement contains institutional provisions, including consultation and dispute settlement and the establishment of a **Council on Services**.

The first annex to the GATS concerns the movement of labor. It permits parties to negotiate specific commitments applying to the movement of people providing services under the GATS. The annex would not apply to measures affecting employment, citizenship, residence, or employment on a permanent basis. It also relates to membership or participation in self-regulatory bodies and securities or futures exchanges. The annex on telecommunications relates to measures that affect access to and use of public telecommunications services and networks. In particular, it requires that such access be accorded to foreign parties on reasonable and non-discriminatory terms. The annex also encourages technical cooperation to help developing countries to strengthen their own domestic telecommunications sectors.

The GATS is structured to address the different “modes of supply,” which represent how countries permit or restrict foreign participation in the different services sectors. The GATS establishes its rules in two ways. First, general obligations are negotiated that bind all member countries. Examples include obligations to provide transparency, regulation of the behavior of monopolies and exclusive services providers, and the granting of most-favored-nation treatment. Second, specific commitments to provide market access and national treatment, as well as special regulatory obligations, are assumed by individual countries as a result of negotiations reached bilaterally or among a group of countries. The objectives of the current round of services negotiations fall into two basic categories. First, efforts to remove restrictions and limitations on market access and national treatment in sectors generally covered in country commitments. Some of the more important sectors that fall into this category are financial, telecommunications, professional, rental and leasing, computer and software implementation, audio-visual, construction, travel and tourism, and transportation services. Second, the GATS Council would like to expand the reach of services sectors covered, such as environmental, energy, express delivery, distribution, and health and education services.

Finally, the GATS Agreement places a focus on the liberalization of trade in services that benefit less developed countries. See Figure 16.3 *Doing Business Internationally*: “Excerpts from the General Agreement on Trade in

<p style="text-align: center;">Article IV</p> <p><i>Increasing Participation of Developing Countries</i></p> <ol style="list-style-type: none"> 1 Increasing the participation of developing countries relating to strengthening of their domestic services capacity, efficiency, and competitiveness through access to technology; 2 Developed countries shall facilitate the access of developing countries' suppliers to information, related to their respective markets, concerning: <ol style="list-style-type: none"> a Commercial and technical aspects of the supply of services; b Registration, recognition and obtaining of professional qualifications; and c Availability of services technology. <p style="text-align: center;">Article XVI</p> <p><i>Market Access</i></p> <p>In sectors where market-access commitments are made, countries shall not maintain.</p>	<ol style="list-style-type: none"> a Limitations on the number of services suppliers, whether in the form of quotas, monopolies, exclusive service suppliers, or by the requirements of an economic needs text; b Measures that restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; c Limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the value of individual or aggregate foreign investment. <p style="text-align: center;">Article XXIII</p> <p><i>Dispute Settlement and Enforcement</i></p> <p>If a Member (country) should consider that any other Member fails to carry out its obligations or specific commitments under this Agreement, it may with a view to reaching a mutually satisfactory resolution of the matter have recourse to the Dispute Settlement Understanding (DSU). [See Chapter 5's discussion of the DSU.]</p>
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Figure 16.3 *Doing Business Internationally*: Excerpts from the General Agreement on Trade in Services.

Services.” Recent trade negotiations, after the 2001 collapse of the Doha Round of trade negotiations (see Chapter 5), have increasingly emphasized the need for the developed world to help the lesser developed world to gain access to technology and services.

Services and the Internet

An evolving issue is the role of e-commerce and how the GATS commitments can be responsive to the new opportunities for providing services over the Internet. In nearly all sectors, there will be increasing pressure to allow services to be provided across borders. For example, in the case of financial services, regulators will be challenged to justify the requirement to provide these services through a local subsidiary, when the service can be provided more efficiently from abroad. However, there is also the possibility that nations and free trade areas will respond with specialized laws aimed at controlling cross-border transactions over the Internet. Consumer protection laws are likely to be tailored to protect nationals engaged in Internet transactions with foreign sellers. An example of such a law is the **EU Directive on Distance Contracts**,⁵ which is described in Figure 16.4 *Comparative Law*: “Protection of Consumers in Distance Contracts.”

As in most consumer protection statutes, the EU Directive on Distance Contracts requires the (foreign) seller to disclose certain types of information. The required disclosure information includes location of seller, price and additional costs, and the minimum length of time that the consumer will be bound to the contract. The Directive allows the seller to solicit over the telephone, but it is required to follow up with a written confirmation. An e-mail confirmation does satisfy the writing requirement. The statute mandates a consumer right of withdrawal. The consumer has up to seven days to cancel the contract and receive a full refund of any monies paid. The right of withdrawal is extended to three months in the event that the seller has failed to provide the information required by the Directive. This consumer right is akin to the right of rescission found in some federal and state consumer protection statutes in the U.S.

It is important to note the last paragraph of the Directive. This prevents the seller from avoiding the dictates of the statute by inserting a choice of law clause selecting a country outside of the EU. Therefore, a choice of law clause selecting the State of California as the law of the contract would be ignored in a case over a dispute pertaining to

<i>Rights of Consumer</i>	
1	Prior to the conclusion of any distance contract, the consumer must be provided with clear and comprehensible information concerning the identity and possibly the address of the supplier; characteristics of the goods <i>or services</i> and their price; delivery costs; arrangements for payment, delivery, or performance; existence of a right of withdrawal; period for which the offer or the price remains valid and the minimum duration of the contract, where applicable; and cost of using the means of distance communication.
2	This information must comply with the principles of good faith in commercial transactions and the principles governing the protection of minors. In the case of telephone calls, the caller's identity and commercial purpose must be made clear at the beginning.
3	The consumer must receive written confirmation or confirmation in another durable medium (electronic mail) at the time of performance of the contract. The following information must also be given in writing: arrangements for exercising the right of withdrawal; place to which the consumer may address complaints; information relating to
	after-sales service; and conditions under which the contract may be rescinded.
4	The consumer has a right of withdrawal. Where the supplier has met his obligations relating to the provision of information, the consumer has at least seven working days to cancel the contract without penalty.
5	Where the supplier has failed to meet his obligations as regards information, this period is extended to three months. The supplier is obliged to repay the amounts paid by the consumer within thirty days.
6	Where the supplier fails to perform his side of the contract, the consumer must be informed and any sums paid refunded. In some cases it is possible to supply an equivalent good or service.
7	Where unsolicited goods are supplied, the consumer's failure to reply does not constitute consent.
8	The use by the supplier of automatic calling devices or faxes requires the prior consent of the consumer.
9	The Member States must ensure that consumers are allowed judicial or administrative redress so that they are not deprived of protection under the law of a non-Member country.

Figure 16.4 *Comparative Law: Protection of Consumers in Distance Contracts.*

Source: EU Directive 97/7/EC.

issues covered by the Directive. California law would still apply, however, to contract disputes not covered under the Directive. Finally, the statute does not prevent member countries of the EU from enacting more stringent consumer protection legislation. The U.S. exporter, unfortunately, will not only have to satisfy the dictates of the Directive, but will also have to research the consumer protection requirements of each EU country it chooses to export to.

Hiring Foreign Personnel

Any company seeking to sell its products internationally will face the need for foreign representation. It will be forced to enter the market for services. For example, an exporter contemplating an initial penetration into a foreign market has three alternatives for entry. First, it may elect to use employees, whether those already in place or new foreign hires. Second, it may elect to hire independent contractors to provide the needed services. The most common form of service provided by independent contractors is sales representation. Third, it may elect to enter into a distribution relationship with a foreign distributor. It is estimated that over half of world trade is handled through sales representatives and distributors.⁶

A **foreign sales representative** is an agent who distributes, represents, services, or sells goods on behalf of foreign sellers. The following sections will focus upon the differences between the employment and independent contractor relationships, why those differences are important, and on the law pertaining to the use of foreign sales representatives and distributors. Although the employment or **independent contractor** relationships are largely matters of private contracting, foreign laws heavily impact the classification of a given relationship. Also, once a relationship is designated as an employment or independent contractor relationship, a number of host country laws regulate areas such as notice, termination, and remuneration.

The terminology of agency, employment, and independent contractor as used in the United States may differ from the way it is used in other countries. For example, the general meaning of *agent* may differ from country to country. Generally, an agent denotes the person being hired while the party doing the hiring is referred to as the *principal*. The term *agent* encompasses both dependent and independent agents. An employee is a *dependent*

agent. A mixture of employment and agency law governs the employer–employee relationship. In contrast, an independent contractor, such as a consultant, is an *independent agent*. Agency law governs the principal–agent relationship between the hiring company and the consultant. It will be seen, however, that in some foreign legal systems this relationship is subject to a good amount of statutory control. The next two sections will examine the general nature of the employment and independent contractor relationships.

The Employment Relationship

The philosophical foundation of the U.S. employment relationship, the **employment-at-will doctrine**, provides that except for express employment contracts the employment relationship may be terminated at the will of either party. In order to prevent employee-generated lawsuits of unfair dismissal, companies should avoid the use of employment contracts and make clear at the time of hiring that the employment is “at will.” A U.S.-based international company’s employment manual should make this clear. First, the manual should state that the general employment policy applies to all subsidiaries. Of course, one should bear in mind that the “at will” concept may be defined differently in other legal systems.

Second the employment manual should clearly state that: “all employees are hired as *at will* employees.” The employer’s code of conduct (ethics code) should also delineate prohibited areas of conduct, such as rude or discourteous behavior, theft or personal dishonesty, use or possession of alcohol or controlled substances on company premises, maintenance of inappropriate files on the company’s internal network, transmission of confidential information over the e-mail system, disclosing nonpublic information including trade secrets, duplicating software products, and engaging in any act of harassment or discrimination.

The employer should pay special attention to the last item on the above list. Laws and cultural attitudes vary widely among countries. Therefore, a clear policy on sexual harassment should be developed with the international employee in mind. Figure 16.5 *Doing Business Internationally*: “Standard Sexual Harassment Policy” provides a common format for developing a company’s **sexual harassment policy**. At the minimum, a policy should state the company’s general policy, provide workable definitions of inappropriate conduct, and provide a user-friendly complaint procedure. The problems of cultural or ethical relativism were discussed in Chapter 2. Based upon that discussion, should a U.S. company tailor a policy or modify its existing policy to take into account more relaxed cultural and legal standards of sexual harassment? How can such modifications be justified?

The employment relationship is viewed differently culturally and legally throughout the world. The perspective of legal status of the employee varies from the employment-at-will doctrine in the United States to

<p style="text-align: center;">General Policy</p> <p>Management personnel are responsible for maintaining a harassment-free environment and are strictly prohibited from stating or in any way implying that submitting or refusing to submit to sexual advances will have any effect upon an individual’s hiring, placement, compensation, training, promotion, or any other term or condition of employment.</p> <p style="text-align: center;">Definition</p> <p>All employees are prohibited from making offensive remarks or engaging in unwelcome overtures, either verbal or physical. Such prohibited conduct includes, but is not limited to, offensive and unwelcome flirtations, advances, or propositions; verbal abuse of</p>	<p>a racial, ethnic, religious, or sexual nature; graphic or degrading comments about an individual or his or her appearance; the display of sexually suggestive objects or pictures; or any offensive or abusive physical contact. Acts of harassment by any employee are strictly prohibited and will result in disciplinary action that may include termination of employment.</p> <p style="text-align: center;">Complaint Procedure</p> <p>When a complaint is received the company’s ethics officer or human resources department will conduct an immediate impartial and confidential investigation. At the conclusion of the investigation, the officer or representative of human resources will advise the employee of the results.</p>
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Figure 16.5 *Doing Business Internationally*: Standard Sexual Harassment Policy.

(Three typical sections of a sexual harassment policy.)

employment as a property right in Germany. Understanding these differences is vital to the U.S. manufacturer contemplating the hiring of foreign nationals. In Germany, for example, hiring a single employee can result in the company being designated as having “permanent status,” leading to the taxation of the exporter’s German-generated revenues. Thus, designating a German national as an independent contractor in a clearly written contract is prudent.

The decision to hire foreign employees, especially in most EU countries, should be made with full knowledge of the obstacles the employer has to overcome under European law in order to terminate the employment relationship. In Germany, the notice required to discharge an employee may vary from four weeks to seven months depending on the longevity of the employment. Dismissals are permitted only following consultation with statutorily mandated **Works Councils**. Also, workers can sue for reinstatement and damages if the dismissal is determined to be “unjustified.” A number of protected classes, such as pregnant women and members of the Works Council, are not subject to dismissal. Furthermore, severance payments can reach as high as a full year of salary or more for long-term employees. Thus, the decision to employ should be cautiously entered into.

Under the **French Labor Code**, a meeting with the employee being discharged and notice are required, making immediate termination impossible. A suit for unfair dismissal, like in Germany, is recognized. In order to avoid civil sanctions for breach of contract, the employer must be able to prove that there were real and serious grounds for the dismissal. The employee also has a right to a severance payment based upon seniority. He may waive this right in favor of a statutorily mandated **conversion contract**. Under the conversion contract, the employee receives, at the cost of the employer, enhanced government unemployment benefits and retraining or educational opportunities. If the ground for dismissal is economic, then the discharged employee has: (1) a right to a transfer if another position is available within the company and (2) a right to reemployment for a period of one year in the event that the economic factors change.

In France, dismissals for reasons of **redundancy** are allowed under certain conditions. Redundancy is the term for “laying off” workers no longer needed because of a restructuring or downsizing. The employer may make such collective dismissals only following consultation with labor unions. Also, the selection of workers to be dismissed must be based upon the criteria established by law that factors in the number of family dependents, seniority, and organizational needs.

The employment relationship in the former countries of the Soviet Union remains heavily regulated. For example, the **Russian Labor Code** makes it very difficult for the employer to terminate employment. Another policy grants maternity leave for up to *three years* per child. Furthermore, the written contract is the basic form for commencing an employment relationship that must satisfy detailed requirements before an employee can be dismissed. Therefore, before dismissing an employee, it is important to seek legal consultation.

In Italy, trade unions are given standing to sue employers under the law for any violations of rules pertaining to union membership or activities. The law provides for the issuance of injunctions against the employer. The trial is required to begin within two days of the filing of a *recorso* or complaint by the trade union.

A fundamental difference in Italian law is that an employer’s freedom to hire is limited. The placement of workers is considered to be a matter of public concern to be implemented by the government. A number of agencies are given the responsibility to place workers. These include the Ministry of Labor, the Central Employment Commission, along with regional and provincial employment offices. The employer is required to file an application with the Placement Office indicating the category and qualifications sought. The Placement Office then selects workers among those registered on its **hiring list**. Unemployed workers are given priority over those wanting to change jobs. This procedure is known as *annunzio numerica* or **hiring by number**.

Recently, the Italian hiring by number practice has been liberalized to enable employers to engage in more direct hiring. Employers are now allowed to hire directly: (1) managers and other workers performing managerial duties, (2) 50 percent of all other workers that they were previously required to hire through the Placement Office, and (3) workers paid wholly on a profit-sharing basis. Italian law also includes a provision for **compulsory hiring**. The law provides that companies employing more than 35 employees must hire 15 percent of its workforce from the

following categories of people: war disabled, work disabled, blind, deaf, or mute people and orphans and widows by reasons of military service or work.

In the area of termination, the employer must follow a statutory **consultation procedure** that includes the giving of notice provided for either in the collective bargaining agreement or by custom and practice (see Figure 16.6 *Comparative Law: “Italian Consultation Procedure”*). Failure to give notice obligates the employer to pay an **indemnity in lieu of notice**. The indemnity payment is an amount equal to the pay the worker would have received for the period of the required notice. In reviewing the Italian consultation procedure a U.S. employer is likely to be astonished by the complexity of dismissing an employee, the broad rights accorded the employee, and the size of the mandated employee benefits. On average, it can take about three months to dismiss an employee. The employee is given a right to reemployment for up to one year following her dismissal. In addition, the employee is entitled to up to three years of indemnity (unemployment) paid through contributions by the employer to the National Social Security Institute!

The employer in Italy may terminate an employee without notice where the dismissal is for cause. **Dismissal for cause** is defined as something grounded on such grave misconduct, whether intentional or negligent, that the employment relationship is no longer capable of being reasonably continued. Reasons short of theft are unlikely to justify a dismissal for cause. In short, employers are subject to strict conditions when terminating their employees. The dismissal must be based upon *justified reasons* such as closing a product line, notice must be in writing, and it must give the reasons for the dismissal. Failure to comply with this procedure results in a continuation of the employment.

Any discharged worker may contest her dismissal within 60 days and seek a settlement before a Conciliation Committee. If no settlement is reached the worker may bring suit for wrongful dismissal. The burden of proof in such a lawsuit is placed upon the employer. If a court rules that the dismissal was unlawful, then the employee is entitled to damages ranging from five months to fourteen months of salary and the employer may be required to rehire the discharged employee.

International Labor Standards

Labor regulation has become a controversial issue in both the regional and global contexts. In the global arena, national and international labor groups have criticized the creation of the WTO with its narrow mandate of fostering free trade. These groups believe that free trade agreements should be made conditional on respect for labor standards. Thus far the WTO has rejected demands to adopt standards for the regulation of labor.

1	The employer must give written notice to the union of intention to dismiss workers.	6	The discharged workers are placed on a <i>mobility list</i> and shall be given priority for reemployment by the original employer for a period of one year.
2	A meeting with the union must be held within seven days of the receipt of the notice to discuss how to avoid the dismissals (such as the possible relocation of workers).	7	The dismissed workers are entitled to a notice period or an indemnity in lieu of notice.
3	If after 45 days a settlement has not been concluded, then they shall continue before the Regional Labor Office or, where the dismissals involve different locations, then before the Ministry of Labor.	8	Dismissed workers are also entitled to a <i>mobility indemnity</i> paid by the <i>Istituto Nazionale della Previdenza Sociale</i> (National Social Security Institute or INPS). The indemnity is paid for a period of 12 months for workers under the age of 40, 24 months for workers over 40, and 36 months for workers over the age of 50. The employer contributes to this indemnity by paying to INPS an amount equal to nine times the monthly “conventional salary.”
4	Negotiations before the Ministry or Labor Office shall not exceed 30 days.	9	Workers are also entitled to <i>termination dues</i> normally equivalent to one month of salary for each year of service.
5	If an agreement is not reached before the expiration of the above time limits, then the employer has the right to terminate the redundant workers.		

Figure 16.6 *Comparative Law: Italian Consultation Procedure.*

Contractor agrees to ensure working conditions not less favorable than those established for work of the same character in the trade or industry where the work is carried on by collective agreement or other recognized machinery of negotiations between employers

and workers. Where such agreements are not in existence, then those working conditions that are at "the general level observed in the trade or industry in which the contractor is engaged by employers whose general circumstances are similar."

Figure 16.7 *Focus on Transactions*: ILO Labor Clauses in Public Contracts.

Historically, the **International Labour Organization (ILO)** has been associated primarily with the development of international norms applicable to labor issues. The Treaty of Versailles established the ILO in 1919 with the stated principle that "labor should not be regarded merely as a commodity or article of commerce." A common device used to advance labor standards is the inclusion of **labor clauses** in trade agreements (see Figure 16.7 *Focus on Transactions*: "ILO Labor Clauses in Public Contracts"). This was expressly done in regional free trade agreements such as the North American Free Trade Agreement (NAFTA) and more specifically in EU legislation, but was rejected in the enactment of the WTO Agreements.

The **ILO Declaration on Fundamental Principles and Rights at Work** has enumerated a number of "core labor standards" including: (1) freedom of association and the right to collective bargaining, (2) elimination of all forms of forced or compulsory labor, (3) abolition of child labor, and (4) elimination of discrimination in respect of employment and occupation. Note the close relationship between these core labor rights or standards and the basic human rights discussed in Chapter 2. Currently, U.S. law reflects this commitment to core labor rights. For example, a developing country may lose preferential tariff rates for violating labor rights. The Generalized System of Preferences (GSP) law states that reduced tariff rates are to be removed if a "country has not taken steps to afford internationally recognized worker rights to workers in the country." The U.S. Tariff Act of 1930, Section 1307, prohibits the importation of goods produced with prison or indentured labor. In 1997, Section 1307 was amended to include goods produced using forced or indentured child labor. The sporadic implementation of these provisions has been an issue for debate.

The EU has addressed labor standards on a piecemeal basis by incorporating them into agreements on specific activities. For example, EU directives require the insertion of labor clauses in public procurement contracts. Another pro-labor device recognized in Europe is the Works Council discussed above. These employee councils require a company to provide information and seek consultation with its workers on plant and workforce relocations. In 1993, Hoover Europe announced the closing of a plant in France resulting in the loss of 600 of 700 existing jobs. Partially in response to the public outcry, the EU approved a **European Works Council Directive**.⁷ The Directive requires large companies, mostly multinational corporations, to establish European Works Councils (EWC).

Independent Contractor Contract

The designation of a foreign agent as an employee, partner (joint venture), or independent contractor is crucial. If the foreign agent is hired as an independent contractor, then the employment regulations discussed above do not apply to the relationship. Furthermore, the principal (U.S. company) doing the hiring would not be liable for the acts of the independent contractor, as it would be for acts of an employee or partner.

It is important that independent contractor status be preserved both in any written contract and in the actual carrying out of the contractual relationship. The independent contractor agreement should also include a **non-partnership clause** to prevent the principal from being vicariously liable under agency principles. A typical non-partnership clause states that "the party being hired is to perform as an independent contractor and nothing contained herein should be construed as creating a partnership between the parties to this agreement."

In addition, a **work for hire clause** should be inserted into any employment or independent contractor agreement in which the employee or independent contractor is being paid to develop new technology or to perform research

and development. This clause makes it clear that all rights to the research and intellectual property rights are to revert to the employer. A typical work for hire clause reads that “all inventions, creations, and research of the employee (or independent contractor) during the term of his employment shall be work for hire and shall be the property of the employer, and that all rights to the intellectual property shall be assigned by the employee to the employer.”

Foreign Sales Representative

The most common use of the independent contractor vehicle for transacting business is to hire a foreign sales representative. This relationship has been defined as the hiring of an agent “to prospect for and visit customers with a view to negotiating and, when appropriate, concluding sales agreements in the name and for account of the exporter of goods, services, technology.”⁸ This relationship is also referred to as a **commercial agency** arrangement.

The following excerpt from the U.S. State Department’s Country Commercial Guide for Indonesia illustrates some of the nuances in hiring foreign sales representatives and agents:

The main difference between a representative office and an agent is that the former cannot sell or sign contracts but only market and do research, while the latter can perform all trade activities. Only Indonesians can function as agents. Foreign principals often work out a management agreement that allows the foreign company in Indonesia to play a more active role in the marketing efforts of its Indonesian agent or distributor. Whatever basis is used for remuneration, it must be formulated clearly in the agreement, and it must be applicable under the present Indonesian laws. To protect the foreign company’s interests properly, a comprehensive agreement should be drawn between the parties concerned.

A subsequent determination or conversion by a foreign government of an independent sales agent to employment status subjects the exporter to a wide array of foreign laws including tax and labor laws. An employment designation may also “establish” the company for purposes of personal jurisdiction in the courts of that country. Thus, the structuring and wording of the services contract as one of independent agency, and not dependent agency, is crucial for avoiding such host country laws. The profound differences in the area of agency law between civil law and common law countries require the advice of foreign legal counsel when entering such a relationship. The key to exporting to most countries, especially in the initial stages of exporting, is the use of foreign commercial agents and distributors. These contracts are almost always framed as an independent contractor relationship. Chapter 17 will discuss these important areas of international exporting.

Logistical Services

An exporter must comply with foreign packing, labeling, and documentation requirements. Because of the complexity of these requirements, most exporters will enlist the services of freight forwarders and customs brokers. **Freight forwarders** are agents for exporters and importers and are experts at transporting cargo worldwide. Most of the information that follows also applies to customs brokers. However, the services of the freight forwarder are broader in that a freight forwarder provides services pertaining to export requirements, transportation, and importation. The customs broker’s expertise generally revolves around the government requirements for the importation of goods. Freight forwarders are familiar with import and export regulations, methods of shipping, and documentation requirements. They are also a good source for freight and insurance cost information. In a documentary transaction, the freight forwarder can be enlisted to review the letter of credit, bill of lading, and other documents. The freight forwarder can also help in packaging and marking the goods for transport. The freight forwarder will be aware of the internationally recognized symbols for handling and shipping products of all kinds.

Law of Freight Forwarding

The freight forwarder plays a crucial role in the transportation of products under an international sales contract. The services provided by the freight forwarder and, to some extent, the customs broker have expanded in modern times. Traditionally they are engaged to assist merchants in preparing and booking the cargo for carriage. In some cases, freight forwarders act as agents for carriers, particularly liner shipping companies for carriage of goods by sea. Freight forwarding services normally include the clearance of goods for export and import. Also, freight forwarders have cooperating partners in other countries to whom instructions are given for the receipt of the cargo and for customs clearance.

The freight forwarder also plays the important role of **cargo consolidator**. Most exporter shipments require booking only a portion of a ship's cargo space. The freight forwarder can obtain more reasonable shipment rates by consolidating the cargo of a number of its clients. In addition, the demands of international **multimodal transport** have transformed the freight forwarder from a mere agent of the shipper to that of an operator with carrier liability. For a discussion of "multimodal transport" see Chapter 13. The role of the freight forwarder as a common carrier is recognized in Article 19 of the UCP 600. It allows freight forwarders to issue bills of lading if they are acting as a carrier or multimodal transport operator.

The multiple roles played by the freight forwarder lead to some ethical concerns. As the agent of the shipper, the freight forwarder is supposed to work on the shipper's behalf as an unbiased advisor, but its multiple roles may generate temptations to give preferential treatment to certain customers or to work more in favor of the transport companies than the shipper. Thus, the shipper is best advised to perform independent checks on the services being provided.

Advertising Services and Law

National laws dealing with deceptive advertising vary in scope and enforcement. Because of cultural differences, an advertising campaign that is legal in one country may be illegal in another. Almost all developed countries possess laws that make illegal the use of misleading advertising. Advertising laws are policed by administrative agencies, through private litigation, and via industry self-regulation. These three means of enforcement vary dramatically throughout the world. All three are utilized in the United States.

The **Federal Trade Commission (FTC)** regulates virtually all forms of advertising in the United States. It is empowered to prevent "unfair and deceptive practices."⁹ Section 43(a) of the **Lanham Act**¹⁰ created a private cause of action for anyone injured by false advertising. There are also many examples of industry and media self-regulation. One example is the National Advertising Division of the Council of Better Business Bureaus. In contrast, there is no national self-regulation in Saudi Arabia. Instead, a number of agencies, including the Organization for the Prevention of Sins and Order of Good Deeds, seek the enforcement of Islamic laws.

Civil law countries, including Germany, rely on advertising law that authorizes private litigation to control misleading advertising. The Scandinavian countries make use of the consumer ombudsman to enact advertising guidelines and to resolve disputes. Because of the vast differences in advertising law enforcement, it is important for the international entrepreneur to seek local counsel before embarking on a marketing campaign. The local counsel can provide information on the substantive law of advertising. However, most exporters will use private advertisement agencies to handle their marketing campaigns. At a minimum, the prospective agency should be a member of that country's professional advertisement association. For example, in Chile most advertising agencies are members of the *Asociación Chilena de Agencias de Publicidad* (Chilean Association of Advertising Agencies, ACHAP).

Businesses may attempt to minimize the risks of false or improper advertising through insurance. Although insurance is unlikely to protect from government prosecution, it will minimize their exposure to private litigation. The *Heritage Mutual Insurance* case that follows illustrates some of the issues created by the intersection of advertising and insurance law. This case explains the important concepts of **advertising injury** and the **duty to defend**.

Heritage Mutual Insurance v. Advanced Polymer Technology**97 F. Supp. 2d 913 (S.D. Ind. 2000)**

Barker, Chief Judge. This case represents another installment in the ongoing debate about the meaning of “advertising injury,” a popular phrase used to describe a type of insurance coverage provided in standard versions of commercial general liability insurance policies. Plaintiff, Heritage Mutual Insurance Company (Heritage) filed a complaint seeking a declaratory judgment that it has no duty to defend or to indemnify its insured, Advanced Polymer Technology (APT). The policy at issue here, known as the Commercial General Liability (CGL) form, represents a standard policy form written by the Insurance Services Organization (ISO).

While some insurers may alter the forms they receive from ISO and tailor the standard language based upon the unique coverage requested by their insured, insurers often adopt the ISO forms verbatim. Coverage “B” of the CGL policy, entitled “Personal and Advertising Injury Liability,” provided in its “Insuring” clause that Heritage would insure APT for any “advertising injury caused by an offense committed in the course of advertising APT’s goods, products or services.” The policy defined “advertising injury” as injury arising out of one or more of the following offenses: (a) oral or written publication of material that slanders or libels a person or organization or disparages a person’s or organization’s goods, products, or services; (b) oral or written publication of material that violates a person’s right of privacy; (c) misappropriation of advertising ideas or style of doing business; or (d) infringement of copyright, title, or slogan.

One of the policy’s coverage exclusions, the “first publication” exclusion, provides that insurance coverage does not apply to “advertising injury . . . arising out of material whose first publication took place before the beginning of the policy period.” Additionally, the policy established Heritage’s “duty to defend any suit seeking those damages.” Under Indiana law, a contract for insurance is subject to the same rules of interpretation as are other contracts. The insured is required to prove that her claims fall within the coverage provisions of her policy, but the insurer bears the burden of proving specific exclusions or limitations to policy coverage.

The insurer’s duty to defend, which is broader than its duty to indemnify (pay on the claim), is determined by the nature of the claim in the underlying complaint, not its merits. An insurer must defend an action even if only a small portion of the conduct alleged in the complaint falls

within the scope of the insurance policy. When an insurance contract contains an ambiguity, it should be strictly construed against the insurance company.

Environ, a patent owner, claims that APT willfully infringed on its patents. It also accuses APT of “federal unfair competition” under the Lanham Act by contending that APT made “false and misleading statements as to the creation or ownership” of the piping product “in its application for a patent.” The parties have not contended that the patent application constituted an advertisement or an item “in the course of advertising” as required by the Heritage–APT policy. Environ alleges that Defendant APT’s marketing of its POLY-TECH piping system as “patent pending” creates a cloud on its ownership of the invention, thereby discouraging investment in or purchase of its products.

We find it implausible that the parties would have intended that direct and induced patent infringement would be covered under the policy without expressly listing those offenses in the phrase “infringement of copyright, title, or slogan.” Also, the insurer had no duty to defend the insured since the plaintiff’s unfair competition and Lanham Act claims did not qualify as allegations of misappropriation of advertising ideas or style of doing business. The allegation that the insured engaged in unfair competition by misappropriating trade secrets does not allege misappropriation of advertising ideas or styles of doing business as such.

APT claims in abbreviated fashion that Environ’s allegations fall within the “disparagement category” of advertising injury offenses. While we believe that some direct reference to the competitor’s product is necessary to fall within the plain meaning of “disparage,” we also do not view Environ’s allegations as resulting in a reasonable claim of implied disparagement. The phrase “patent pending” signifies nothing about the quality or state of Environ’s product, as the phrase means exactly what it says—a patent is pending.

Heritage’s conduct strikes us as sufficiently reasonable under the circumstances of this case, and, as it turns out, correct as a matter of legal contract interpretation. The reasons supplied for denial of coverage were rational and understandable. We hold that Heritage has no duty to defend its insured because the allegations in Environ’s complaint do not constitute advertising injury offenses.

Case Highlights

- Insurance Services Organization (“ISO”) is a trade association that develops standard insurance forms and clauses.
- “Advertising injury” is a type of insurance coverage provided in standard versions of commercial general liability insurance policies (CGL).
- Under insurance law, the insured is required to prove that her claims fall within the coverage provision of her policy, but the insurer bears the burden of proving specific exclusions or limitations to policy coverage.
- Insurer’s duty to defend is broader than its duty to indemnify.
- When an insurance contract contains an ambiguity, it is strictly construed against the insurance company.

Cross-Border Security Offerings

Companies raise capital in a number of ways including borrowing from banks and accepting investments by venture capitalists. The most common way of raising capital is to sell either debt instruments (bonds) or equity instruments (stock shares). The advantage of selling shares in the company is that it raises capital without incurring a debt obligation. From the investor’s perspective an equity investment, especially in a new company, is made in the hope that the company will be profitable. The internationalization of the capital markets has been one of the major trends in the business world. It is not uncommon for even small or medium investors to allocate a portion of their portfolios to foreign securities. From a legal perspective, this poses questions as to the enforcement and regulation of international securities transactions.

The key issue with the international sale and purchase of securities is how such offerings are to be regulated. Since there is no international policing institution, regulation comes through the enforcement of national regulatory laws. In the United States, the **Securities and Exchange Commission (SEC)** administers federal securities laws. Can the SEC regulate security offerings originating in a foreign country? Can U.S. security laws be applied extraterritorially? It has been deemed fair by U.S. courts “to demand compliance with U.S. laws and regulations of any person or entity who has purposely made a connection with the United States for the sale or purchase of a security, and its conduct has the *effect* of undermining the stability and fair operation of the securities markets within the United States.”

The extraterritorial application of U.S. securities laws follows a standard two-prong test. First, the foreign parties must have had the intent or purpose of selling their securities in the U.S. marketplace. Second, the alleged foreign illegal activities are likely to have an *effect* within the United States. The second prong is commonly referred to as the **effects test**. The effects test has been used to determine the extraterritorial applicability of many U.S. laws such as discrimination, antitrust, and tort law. The effects test stands for the principle that the exercise of jurisdiction is appropriate where the illegal activity abroad injures someone within the United States. However, the effects test does not justify the exertion of SEC jurisdiction where no fraud is committed within the United States and the securities are purchased outside the United States.

Offshore security offerings are those in which the offer to sell is not made to a person in the United States or when a security is sold on a foreign stock exchange. In order to avoid U.S. securities laws a company can take steps to prevent the solicitation of persons within the United States. However, the development of securities transactions over the Internet challenges a company’s ability to avoid SEC jurisdiction.

An offering on the Internet not intended for U.S. investors may still be subject to SEC enforcement actions. The global nature of the Internet can lead to the conclusion that such offers are being made “in the United States” and therefore must be registered with the SEC. The SEC has recently provided guidance, in its “Statement of the Commission Regarding the Use of Internet Web Sites to Offer Securities, Solicit Transactions, or Advertise Investment Services Offshore,” for those wanting to avoid U.S. securities laws in offshore offerings. It suggests that

the offering party take reasonable precautions to guard against making sales to U.S. persons and to place a disclaimer on the offer stating that it is not intended for persons in the United States.

The **International Organization of Securities Commissions (IOSCO)** has made it a goal to achieve the comparability of information required under national securities laws in order to facilitate cross-border offerings and listings by multinational securities issuers. In order to achieve this goal, IOSCO has proposed the development of a generally accepted body of disclosure standards that could be used in a uniform disclosure statement for cross-border offerings and listings. In 1998, IOSCO published its “International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers.” A company planning to sell shares internationally should review these standards when preparing required prospectuses and registration statements.

A problem with international standards is that they fail to provide a definition of **materiality**, which is crucial in determining the accuracy of documents and statements. All countries require that a company or issuer disclose all material information. However, the definition of materiality varies from country to country. The U.S. Supreme Court, in *TSC Industries, Inc. v. Northway, Inc.*,¹¹ defined materiality as follows: “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder or investor would have considered it important.” In Quebec, Canada, materiality is considered as something likely to have significant influence on the value or market price of the securities of a reporting issuer.

The Stock Exchange of Hong Kong’s Listing Rules defines *materiality* as the disclosing of information “necessary to enable an investor to make an informed assessment of the activities, assets and liabilities, financial position, management, and prospects of the issuer.” In contrast, the EU does not use the concept of “material” and therefore does not provide any definition of materiality. Japanese disclosure rules provide numerical guidelines for determining materiality.

Internationalization of Accounting and Taxation Services

The internationalization of business has placed pressure upon the accounting profession to provide necessary support services. Accounting services, as with most professional services, can be internationalized on a number of fronts. First, domestic regulations can be modified to take into account the special issues of cross-border transactions. Second, international standards can be enumerated for professional services. Third, countries can recognize each other’s professional qualifications and national standards. The adoption of harmonized international standards provides the greatest possibility for increased trade in international accounting services. The areas where international accounting services are needed include transfer pricing, currency translation, and joint venture accounting.

Transfer pricing refers to a method of tax avoidance. In structuring contracts between itself and its foreign subsidiaries, a corporation will often attempt to recognize or transfer any profits to subsidiaries located in low-tax countries. The U.S. Internal Revenue Service requires that such intracompany transactions be conducted at *arm’s length*. Contract prices between affiliated companies are to be set at market or reasonable prices. Therefore, multinational corporations need to develop a transfer pricing policy that will be generally accepted in the countries that they do business in. This is needed in order to avoid complicated tax disputes and the potential for double taxation. Tax planning should be done on a country-by-country basis. For example, the social security rates in EU countries range from 20 percent to as high as 40 percent. Some guidance can be obtained through the use of recently developed guidelines for transfer pricing and documentary requirements produced by the OECD.

One approach for taxing multinational corporations or cross-border business transactions is through **unitary taxation**. It is an approach in which corporate profits are apportioned to the different taxing authorities using a formula based on sales, payroll, and property within each jurisdiction. Transfer pricing issues become more confusing in the growing area of international Internet or electronic commerce.

Currently, the two most influential bodies in the movement to harmonize accounting standards and financial statements are the International Accounting Standards Committee (IASC) and the International Organization of

Securities Commissions. The diversity of accounting practices throughout the world is an encumbrance to the development of truly global capital markets. Companies currently wishing to raise capital in foreign markets have to contend with costly and complicated national disclosure and reporting requirements. The ability to provide comparable financial statements to be used in cross-border security offerings would significantly decrease the number and types of required filings.

The EU Commission has sought to harmonize reporting requirements at the regional level. At the international level, IASC has developed a number of **International Accounting Standards (IAS)**. IOSCO has deferred to IASC by accepting IAS and has focused its attention on developing a common international prospectus that could be used for listing and filing in all exchanges. These efforts will continue and are essential to further enhance the free flow of capital and related services.

Chapter Summary

- 1 Exporting–importing of services makes up a large part of international trade, along with the exporting–importing of goods, foreign direct investment, and the licensing of intellectual property rights or technology. The United States is a major exporter of services, especially in such areas as technical and business services such as IT, software development, accounting, legal, human resources, engineering, and customer services (contact centers), as well as research and development. Trade in services has continued to expand with the growth of the Internet and the development of the share economy.
- 2 The importance of trade in services was recognized by the World Trade Organization (WTO) with the adoption of the General Agreement on Trade in Services (GATS). The GATS agreement applies the general WTO principles—national treatment, most-favored nation, and transparency—to the trade in services. The GATS agreement places a strong emphasis on the liberalization of services to benefit developing countries.
- 3 Liberalization and harmonization of the trade in services has also been targeted at the national and regional levels. The United States and other countries have entered into Mutual Recognition Agreements (MRAs) to recognize each other’s certification procedures for industries and professionals that provide services; the European Union has numerous directives aimed at creating a common market in services; and nongovernmental groups, such as the Trans-Atlantic Business Dialogue (TABD), aim to harmonize standards related to electronic commerce.
- 4 With the explosion of sales of goods and services via the Internet, the European Union has passed a number of directives, such as Directive on Distance Contracts, aimed at protecting consumers.
- 5 Providing services entails the hiring of either employees or independent contractors. The sale of goods is intimately connected with the sale of services as exporters hire foreign representatives, commercial agents, freight forwarders, and distributors to provide numerous services, such as transport and logistics, marketing and sales, and distribution. Chapter 17 focuses on the commercial agency and distributorship relationships; this chapter focuses on the employment relationship.
- 6 When hiring foreign personnel such as foreign sales representatives it is preferable to hire them as independent contractors than as employees. Numerous countries, such as France, Germany, Italy and Russia have pro-employee laws that provide employee protections and benefits at the time of termination. For example, the United States follows the employment-at-will doctrine, while German and Italian employment law see the worker as gaining “property rights” to job security.
- 7 It is generally accepted that workers’ rights, such as a right to be treated with respect, in a nondiscriminatory way, the right to unionize, and the obligation of the employer to provide a safe and healthy workplace, are inseparable from basic human rights (see Chapter 2). The International Labour Organization (ILO) has enunciated “core labor standards” in its *Declaration on Fundamental Principles and Rights at Work*.
- 8 A number of services that have increasingly transcended national borders have been subject to increased scrutiny and regulation, including logistical services and the law of freight forwarding, accounting and tax services, advertising, and cross-border securities offerings.

Key Terms

Advertising Injury	French Labor Code	Multimodal Transport
Cargo Consolidator	General Agreement on Trade in Services (GATS)	Mutual Recognition Agreements (MRAs)
Commercial Agency	Hiring by Number	National Treatment
Compulsory Hiring	Hiring List	Non-Partnership Clause
Consultation Procedure	ILO Declaration on Fundamental Principles and Rights at Work	Office of Service Industries
Consulting Contract	Indemnity in Lieu of Notice	Organisation for Economic Co-operation and Development (OECD)
Conversion Contract	Independent Contractor	Recognition Requirements
Council on Services	International Accounting Standards (IAS),	Redundancy
Customs Modernization Act of 1993	International Labour Organization (ILO)	Russian Labor Code
Dismissal for Cause	International Organization of Securities Commissions (IOSCO)	Securities and Exchange Commission (SEC)
Duty to Defend	Labor Clause	Sexual Harassment Policy
Effects Test	Lanham Act	Trans-Atlantic Business Dialogue (TABD)
Employment as a Property Right	Less Developed Countries (LDCs)	Transfer Pricing
Employment-at-Will Doctrine	Materiality	Transparency
EU Directive on Distance Contracts	Mixed Sales	Unitary Taxation
European Works Council	Most-Favored Nation	Work for Hire Clause
Evergreen Statutes		Works Council
Federal Trade Commission (FTC)		
Foreign Sales Representative		
Framework Agreement		
Freight Forwarder		

Chapter Problem

- Review the following consulting agreement. What are the purposes of the different clauses? Would these clauses be enforceable in the United States and in the European Union? How would you improve this agreement? How would you make this agreement more pro-principal or more pro-agent?
CONSULTING AGREEMENT
This Agreement dated April 11, 2001, is made by and between Joe “Hot Shot” Muldune of Menton, France (“Consultant”), and Gator Exporting of Gainesville, Florida (“Company”). The above parties agree as follows:
 - Services. The Company employs the Consultant to perform certain consulting services. The Consultant will consult with the officers and employees of the Company concerning matters relating to the selling, marketing, and advertising of Company’s products in the country of France.
 - Term. The agreement shall begin on June 1, 2001, and terminate on May 30, 2004. Either party may cancel this agreement on thirty-day notice to the other party in writing, by certified mail or personal delivery.
 - Time Devoted by Consultant. It is anticipated that the Consultant will spend approximately 35 hours per week in fulfilling his obligations under this agreement. The amount of time may vary from week to week. However, the Consultant will devote a minimum of 100 hours per month to its duties in accordance with this agreement.
 - Place of Services. The Consultant will perform services at a location of Consultant’s discretion.
 - Compensation. The Consultant will be paid at the rate of \$125 per hour of work performed. However, the Consultant will be paid a minimum of \$15,000 per month regardless of the time actually spent. The Consultant will send

an itemized statement, on a monthly basis, setting forth the services and time rendered. The Company shall remit payment within 15 days of the receipt of each itemized statement.

- 6 Independent Contractor. The Company and Consultant agree that the Consultant is being hired as an independent contractor. Accordingly, the Consultant shall be responsible for payment of all taxes arising out of the Consultant's activities, including but not limited to income tax, social security tax, and unemployment insurance taxes.
- 7 Confidential Information. The Consultant agrees that any information received from the

Company which concerns the personal, financial, or other affairs of the Company will be treated in full confidence and will not be disclosed to any other persons or companies.

- 8 Subcontractors. The Company may from time to time request that the Consultant arrange for the services of third parties. The Company will pay all costs to the Consultant but in no event shall the Consultant employ others without the prior authorization of the Company.

IT IS HEREBY AGREED THIS 5th day of May, 2001

Joe Muldune Gator Exporting

Internet Exercises

- 1 The most recognized authority on international labor standards is the International Labour Organization (ILO). Review the ILO web site at <http://www.ilo.org> and become familiar with its standards and its current activities.
- 2 Research some of the following industry organization web sites for information on exporting services in those specific sectors.
 - *Management and Public Relations:* Public Relations Society of America at <http://www.prsa.org>; Society for Human Resource Management at <http://www.shrm.org>.
 - *Insurance Services:* American Insurance Association at <http://www.aiadc.org>.
 - *Information Technology:* International Federation for Information Processing at <http://www.ifip.or.at>; Society for Information Management at <http://www.simnet.org>.
 - *Healthcare:* Healthcare Information and Management Systems Society at <http://www.himss.org>.
 - *Franchising:* International Franchise Association at <http://www.franchise.org>.
 - *Environmental Technologies:* National Association of Environmental Professionals at <http://www.naep.org>.
 - *Banking and Financial Services:* Financial Management Association International at <http://www.fma.org>.

Other Internet Sources

Organisation for Economic Co-operation and Development (OECD): <http://www.oecd.org>.
Review major objectives of the **General Agreement on Trade in Services (GATS)**. See WTO web site at https://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm and https://www.wto.org/english/tratop_e/serv_e/serv_e.htm.

International Labour Organization: <http://www.ilo.org>.

American Association of Advertising Agencies: <http://www.aaaa.org>.

American Advertising Federation: <http://www.aaf.org>.

Association of International Accountants: <http://www.aia.org.uk>.

Notes

- 1 U.S. Commercial Services, *A Basic Guide to Exporting* (ed. D. Barry, 11th ed. 2015).
- 2 OECD member countries include Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. See <http://www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm>.
- 3 C. Verrill, Jr., P. Jordan and T. Brightbill, "International Trade," 32 *International Lawyer* 319, 326 (1998).
- 4 WTO Secretariat, *A Handbook on the GATS Agreement* (2005).
- 5 This Directive applies to sales of both goods and services through distance contracts such as mail order, telephone communications, or other means of telecommunications.
- 6 See King, "Legal Aspects of Appointment and Termination of Foreign Distributors and Representatives," 17 *Case Western International Law Journal* 91 (1985).
- 7 Directive 94/45/EC of 22 September 1994.
- 8 ICC, *Guide for the Drawing Up of Contracts—Commercial Agency* 5 (1993).
- 9 15 U.S.C. § 45(a)(1) (1982).
- 10 15 U.S.C. 1125(a) (1988).
- 11 426 U.S. 438 (1976).

HIRING AGENTS AND DISTRIBUTORS

A manufacturer-exporter of goods will often need representatives in foreign countries to market and sell their goods. These foreign sales representatives may be employees or independent contractors, such as commercial agents and foreign distributors. Chapter 16 reviewed the employment relationship in the cross-border setting. This chapter will review the important role played by independent commercial agents and distributors. Selecting a sales representative, commercial agent, or distributor is one of the most important decisions that an exporter must make. In the case of an exclusive distribution agreement, the successful exporter often relies on the expertise of a commercial agent or a foreign distributor.

Choosing the Form of Relationship

National laws vary widely on the meaning of designating a foreign represent as an **agent**. Often, under many national laws, an agent can bind the **principal** (manufacturer-exporter) to contracts with third-party customers, either through **actual** or **apparent authority**. However, across countries apparent authority may or may not be presumed in specific situations. In beginning a new agency or distribution relationship, the exporter should not initially give a foreign sales representative the ability to bind it to contracts with third parties. Instead, although inconvenient, the exporter should retain the right to approve or disapprove any such contracts. In the United States, depending on the agent's title and characteristics, apparent authority is often presumed. However, in international practice actual or apparent authority is not presumed. In such cases the foreign purchaser should ask for proof of the agent's authority to bind the exporter.

Apparent Authority: An agent's power to act on behalf of a principal, even though not expressly or impliedly granted. This power arises only if a third party reasonably infers, from the principal's conduct, that the principal granted such power to the agent.

Sales representatives or commercial agents are considered to be independent intermediaries that broker deals between exporters and foreign customers. They are generally compensated by payment of commissions per contract brokered. If the sales representative receives a salary, then it may be considered an employee under most national laws. A foreign distributor is also independent, but buys the goods on its own account and is compensated by making profits on reselling the goods. The difference between distribution sales and simple sales of goods is that in the distribution relationship the parties interact on an on-going basis, the parties need to cooperate to a high degree to keep the distribution of the goods efficient and reliable, and the distributor has obligations to the manufacturer-exporter that an ordinary buyer does not. There are, also, distribution franchises, which is simply a franchise for the distribution of goods, which would be covered under franchise law.

From the perspective of the exporter the independent distributor relationship is less risky because the distributor assumes the risks of loss due to not being able to sell the goods at a profit. The risk to the exporter occurs if it selects

the wrong distributor and is tied to a longer-term supply contract, resulting in lower sales of its products. Also, the costs of paying commissions to commercial agents to broker deals directly with customers will be less than the selling of goods indirectly through a distributor, which requires a discounting of the price of the goods.

The distribution agreement is a type of commercial agency relationship. It is also an example of a common form of service contract. Engaging the services of a foreign distributor is the most important decision that an exporter of goods will make. Foreign exporting often rises or falls based upon the strength of the exporter–distributor relationship. Importing goods to a foreign country is of little benefit unless the goods can be sold and delivered to consumers in an efficient manner. It is the job of the foreign distributor to get the goods to market. The following sections briefly review the choices that an exporter has in how it markets, sells, and export its goods.

Sales Representative

An overseas sales representative is the equivalent to the manufacturer’s domestic representative. The representative uses the company’s product literature and samples in presenting the product to potential buyers. The sales representative may operate on either an exclusive or a nonexclusive basis. Ordinarily, a representative handles many complementary lines that do not conflict. The sales representative usually works for a commission, assumes no risk or responsibility, and is under contract for a definite period of time (renewable by mutual agreement).

Commercial Agent

The terms *foreign representative* and *commercial agent* are often used interchangeably. A representative commonly acts as an agent for the manufacturer-exporter. The distinction made here is that a foreign representative may either be an employee or an independent contractor, while a commercial agent is considered to be an independent contractor. This chapter focuses on the commercial agent and distributor as independent contractors.

Distributors

The foreign distributor is a business that purchases goods from an exporter (at a discount) and resells them for a profit. The foreign distributor generally provides support and service for the product. The distributor usually carries an inventory of products and a sufficient supply of spare parts and also maintains adequate facilities and personnel for servicing broken or defective products. Distributors typically handle a range of non-competing, complementary products. The distributor often sells to retailers or dealers.

In selecting a distributor for the first time, it may be prudent to keep the duration term of the contract to a relatively short trial period followed by a lengthier extension. It is essential to get expert legal advice pertaining to the market in which the agreement will be in force. Some countries have laws that may affect your ability to terminate the distribution contract.

Foreign Retailers

Exporters may also sell directly to foreign retailers, although in such transactions products are generally limited to consumer lines. The growth of major retail chains in markets such as China and Canada has created new opportunities for this type of direct sale. The approach relies mainly on traveling sales representatives who directly contact foreign retailers.

Exporter–Distributor Relationship

There are numerous reasons that an exporter may use a foreign distributor instead of directly selling to customers in a foreign country. First, it lowers the costs of marketing and transporting the goods in the foreign country. Second, the appropriate distributor will already have an established distribution network in the country and will possess the

expertise to introduce the goods to the market. Small and medium-sized companies that do not have the capital to adequately advertise, comply with foreign regulations, and distribute their goods are unlikely to penetrate a foreign market without the aid of distributor. The small exporter will need to find the right distributor who will be willing to market its products. This will be a distributor that sells multiple product lines from numerous companies in order to obtain an economics of scale that would not be possible for the small company to create alone. Third, the distributor takes on the responsibilities of complying with the foreign country's laws and regulations.

American companies new to exporting can make use of **U.S. Commercial Service** in the Department of Commerce. The Service can promote your products abroad through trade fairs, advise the exporter on the various requirements for exporting and importing goods, provide the names of dependable customs brokers and freight-forwarders, and, most importantly, it maintains a list of reputable distributors for most countries of the world, which may be accessed through **Agent-Distributor Searches (ADS)**. The U.S. International Trade Administration offers a fee-based service that locates foreign agents and distributors and provides **Customized Market Analysis (CMA)** reports that identify potential foreign representatives.

A company should develop a checklist of factors to be used for the selection of a foreign distributor. Each company's checklist should be tailored to reflect the types of products or services being sold and characteristics of the countries targeted for export. See Figure 17.1 *Doing Business Internationally*: "Factors in Choosing a Foreign Distributor."

Common duties assigned to the distributor include: (1) marketing of the product, (2) loyalty to the manufacturer-exporter (noncompetition clause), (3) buying and selling the goods in its own name, and (4) complying with all local laws and informs manufacturer of any changes in the law that impact the legality of the product. Other negotiated duties include requiring the distributor to defend the manufacturer from any product liability claims

<p style="text-align: center;">Size of Sales Force</p> <p>How many field sales personnel does the representative or distributor have? What is the company's short and long-range expansion plans? Would it need to expand to accommodate your account properly? If so, would it be willing to do so?</p> <p style="text-align: center;">Sales Record</p> <p>Has its sales growth been consistent? Try to determine sales volume for the past five years. What are its sales objectives for next year?</p> <p style="text-align: center;">Territorial Analysis</p> <p>What territory does it now cover? Is its coverage consistent with the coverage you desire? Does it have any branch offices in the territory to be covered? Does it have any plans to open additional offices? If not, is it able and willing to expand?</p> <p style="text-align: center;">Product Mix</p> <p>How many product lines does it represent? Are these product lines compatible with yours? Would there be any conflict of interests?</p> <p style="text-align: center;">Facilities and Equipment</p> <p>Does it have adequate warehouse facilities? What is its method of stock control? Does it use computers? Are they compatible with yours?</p>	<p>If your product requires servicing, is it equipped and qualified to do so? To what extent will you have to share training costs? If necessary and customary, is it willing to inventory repair parts and replacement items?</p> <p style="text-align: center;">Marketing Policies</p> <p>How is its sales staff compensated? Does it have special incentive or motivation programs? How does it monitor sales performance? How does it train its sales staff? Would it share expenses for sales personnel to attend factory-sponsored seminars?</p> <p style="text-align: center;">Customer Profile</p> <p>Who are its key accounts? What kinds of customers is it currently targeting?</p> <p style="text-align: center;">Principals Represented</p> <p>How many principals is it currently representing? Would you be its primary supplier? If not, how does your percentage compare with other suppliers?</p> <p style="text-align: center;">Promotion</p> <p>Can it help you compile market research information to be used in making forecasts? What media does it use, if any, to promote sales? How much of its budget is allocated to advertising? How is advertising distributed among principals? Will you be expected to contribute funds for promotional purposes? How will the amount be determined?</p>
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Figure 17.1 *Doing Business Internationally*: Factors in Choosing a Foreign Distributor.

related to the goods sold by the distributor; distributor's duty to obey instructions of the manufacturer relating to the distribution of goods; obligation of distributor to provide after-sales services (warranty claims, repair or replace defective goods); spending a minimum fixed amount on advertising and promotion; requiring the distributor to purchase a minimum quantity of the goods; and requiring the distributor to assist the manufacturer as related to protecting the manufacturer's intellectual property rights. In regard to assuming the liability for product liability claims, such a contract provision may be unenforceable under national law. Therefore, it is important that the manufacturer obtain products liability insurance, as well as requiring the distributor to do so. Another common clause prohibits the distributor from selling goods to customers outside of the distributor's sales territory. However, such territorial restrictions are generally unenforceable under European Union Regulation 1983/83.

Consignment

There is an exception to the general rule of distributors (and commercial agents) as independent contractors that buy on their own account. The exporter and distributor may work under a consignment arrangement (see Chapter 14). In a consignment arrangement the ownership or title to the goods remain with the exporter on delivery of the goods to the distributor, instead of the outright sale of goods to the distributor. The first concern is that the risk of loss (damage or theft of the goods) remains with the exporter so appropriate insurance needs to be obtained to cover consigned goods against loss or damage as well as to mitigate the risk of nonpayment.

Under a consignment contract, the exporter (**consignor**) ships the goods to a distributor in a foreign country (**consignee**). The risk of the goods not selling and being returned remains with the exporter. This is different than a distribution contract where the foreign distributor normally purchases the goods and assumes the risks of not being able to resell the goods. A consignment contract is also different from a commercial agency contract where the agent procures a sales contract and the exporter sends the goods directly to the buyer.

From the perspective of the manufacturer-exporter (consignor), the primary issues of concern that need to be dealt with in the consignment contract are: (1) **independent contractor status**, (2) territorial restrictions, and (3) legal compliance in the foreign country. Independent contractor status is important in order for the consignor to avoid the employee protection laws of the country of import, which can be onerous. The EU is noted for **evergreen laws**, which will be discussed later in the section on **commercial agency**. These laws require the exporter to give advance notice, and just cause for the termination of an employee or agent, as well as substantial severance and damages payments. Therefore, the contract should state that the consignee is being hired as an independent contractor and not as an employee or partner. The consignor must also treat the consignee as an independent contractor, meaning it should not attempt to exercise control over the consignee's business. These precautions are likely to allow the exporter to avoid the evergreen laws related to the employment relationship, but the consignee may still be considered a commercial agent. In some countries, especially in the EU, evergreen statutes also protect agency relationships, but these protections are not as costly as those that pertain to employees and can be limited by a properly drafted agency contract.

The parties should negotiate detailed terms in their contract to govern all matters relating to consignment stocks, such as: (1) whether the principal can take back the whole inventory or part of it; (2) whether the agent is allowed to send back unsold goods; and (3) whether that the agent is to take all necessary safeguards to protect the principal's ownership rights. In some countries the creation of consignment subjects the principal to being taxed as a resident.

The exporting on **consignment** is somewhat like a partnership between two independent parties. To succeed, the exporter must partner with a reputable and trustworthy foreign distributor. Figure 17.2 *Doing Business Internationally*: "Exporting on Consignment" provides an example of why and how a consignment-distribution arrangement works.

The exporter-consignor will want to assign the obligation for legal and regulatory compliance to the consignee. The consignee should be knowledgeable in its country's regulations (safety, health, and environmental standards) and is in the best position to obtain necessary government permits, licenses, and approvals. The consignment contract should also expressly state that the consignee is responsible for the payment of taxes and fees related to the sale of the goods.

A U.S.-based manufacturer of electronic components faced challenges in meeting market demand for quick delivery of its products. Many of its clients require just-in-time delivery (delivery almost immediately after placing a purchase order). Just-in-time supply chains reduce the costs of storing and managing inventory for the purchaser. The risk to the exporter-seller is that even a short delay in delivery of the goods exposes it to liability for breach of contract. In order to mitigate the risk, the U.S. manufacturer entered a consigned inventory arrangement with a foreign distributor who receives

and stocks the goods in the foreign country and sells them to the downstream customers. The distributor receives a commission for sales made, and then sends the net proceeds to the U.S. manufacturer as the goods are sold. Due to this arrangement, the U.S. manufacturer is able to increase production and increase foreign sales since the delivery and consignment of goods overseas with a distributor allows for faster delivery to the local market and may actually reduce the manufacturer's direct costs of storing and managing overseas inventory.

Figure 17.2 *Doing Business Internationally*: Exporting on Consignment.

Negotiating a Distribution Contract

Before drafting an international distribution agreement it is imperative to research the law of the distributor's country in order to comply with mandatory legal provisions.¹ Unlike in the United States, the distributor (along with commercial agency) relationship is regulated under some foreign statutes. Some countries, like Saudi Arabia, require distributors to be nationals and register as distributors with the government. Some countries, by statute or case law, require that the distribution agreement provide some minimal level of protection. In France, the case law is rich with instances where judges have ordered additional compensation to be paid by the principal when severing a distribution relationship. Germany recognizes a “**goodwill indemnity**” that is owed to the distributor upon the termination of the distribution agreement. Finally, foreign competition laws need to be researched to see if exclusivity in a distribution agreement will be enforceable. European Union (EU) law has been used at times to challenge territorial restrictions as restrictive trade practices.

Because of the differences in language, culture, and the legal treatment of a foreign distributor relationship, it is important to negotiate a foreign distribution agreement that is detailed regarding the respective duties and responsibilities of the parties. Unlike the standard agency relationship where the sales contract is between the principal and the purchaser (consumer), the distributor generally sells the goods on its own account. The sales contract is between the distributor and the purchaser.

The International Chamber of Commerce's (ICC's) *Guide to Drafting International Distribution Agreements*² outlines the underlying risks of the distribution relationship and the ways to deal with such risks in the distribution contract. A brief review of this guide is a good starting point for analyzing this pivotal contractual relationship. *Distributor* is defined in the guide as “not a middleman, but a dealer who buys goods in order to resell them in his own name, even if he is often called an agent.” Thus, calling a distributor an agent is a misnomer. In contrast, an agent is generally an independent contractor owing certain fiduciary obligations to the principal. It should be noted, however, that a distributor might act as both an agent and as a distributor.

The distributor's relationship with the manufacturer-exporter is purely contractual and is very much akin to a sale of goods transaction. However, it is a special kind of sales relationship because (1) the distributor often deals with the promotion and organization of distribution within its contractual territory, (2) generally the contractual territory is exclusive to the distributor, (3) the transaction is not one-shot but lasts for a certain duration, (4) there exists a certain level of loyalty, namely an obligation to refrain from competition, and (5) the relationship almost always relates to the distribution of brand-name products.

The exporter should include a clause requiring the distributor to use its best efforts to achieve maximum sales, as well as a products liability clause. Both of these clauses are discussed in the next section.

Often the manufacturer will want to ensure that each of its distributors offers the same conditions of sale to their customers, especially regarding guarantees and after-sales service, but the validity of clauses that appear to entail restrictions regarding the types of customers to be solicited, resale pricing, and territorial restrictions is questionable

under some national laws. For example, the laws of France, Germany, the United Kingdom, and the Scandinavian countries should be closely checked especially with regards to the area of retail price maintenance.

The guide stresses how important it is for the distribution agreement to deal with the issue of changes in **key personnel**. If certain employees are considered essential, they should be recognized in the contract. The contract can then provide for termination in the event that essential persons cease to be associated with the distributor. In addition, in order to avoid the reach of evergreen statutes, the contract should specify specific commencement and expiration dates. Setting a fixed term for the agreement will help minimize the chances of large indemnity payments being owed under certain national laws. Also, renewals should be kept to a minimum. In order to minimize the size of indemnity payments, it is better to enter into an entirely new contract at the expiration of the first contract.

Distribution Contract

As noted above, the exporter would want to structure the contract to avoid the payment of damages or indemnity payments upon termination of the contract. Just as importantly, the exporter will want the distributor to take responsibility for host country regulations relating to product compliance with local health, safety, and packaging regulations. The exporter should review foreign income tax and currency control laws as well. A request for payment by the distributor into an account located outside of the host country should be avoided, as a possible violation of the host country's tax law.

Other contract terms of importance that should be included to protect the exporter include: best efforts, products liability, and post-termination clauses. The **best efforts clause** should require the distributor to use best efforts to achieve a maximum number of sales. In order to measure or benchmark what is meant by best efforts, the clause should fix a "minimum sales quota" or annual thresholds of quantity of goods that need to be sold should be specified. This allows the exporter a just cause to terminate the contract or deny a renewal of the contract. The best efforts obligation can be further detailed by requiring the distributor to spend a minimum amount of money on advertising and sales promotion. From the distributor's perspective, the best efforts requirements should be interrelated with the *force majeure* clause so that the distributor is excused from meeting minimum sales obligations in the event that sales are restricted due to unforeseen events, such as the imposition of import restrictions.

It is beneficial to both parties to allocate the risk of products liability claims. The exporter will want to place a **products liability clause** in the contract assigning the risk of product liability claims to the distributor. However, such a clause may be unenforceable under foreign law, which imposes joint liability on both the manufacturer-exporter and the distributor.³ In such cases, the contract should obligate both the parties to obtain a minimum amount of products liability insurance.

Manufacturers often insert **territorial restrictions** limiting the distributor's sales to an assigned territory. One method is to obligate the distributor to send orders from customers outside its territory to either the manufacturer-exporter or to a distributor allocated to the customer's territory. However, such a provision is invalid under **EU Regulation 1983/83**. The distributor cannot be prohibited from making passive sales—those in which the customer seeks out the distributor, but a clause prohibiting a distributor from openly soliciting outside its territory is enforceable under the EU Regulation.

It is important that the contract specify any obligation that will survive the end of the contract. The contract should provide for the disposition of distributor's inventory of products or spare parts. It should provide for the price to be paid by the manufacturer if it is obligated to buy back stock, which is required under some national laws. A clause should deal with the termination of the distributor's use of the manufacturer's intellectual property rights and confidential information, such as customers' lists or databases.⁴

The clause should at the minimum obligate the distributor to: (1) cease using the name and trademarks of the exporter; (2) maintain the confidentiality of manufacturer's trade secrets and confidential information; (3) destroy or return any such information, along with promotional materials; (4) cooperate in the cancellation of any user registrations; and (5) cooperate in transferring after-sales service obligations, such as supplying parts, technical assistance, and guarantee servicing, to a new distributor. The next section provides more detail on protecting a

manufacturer-exporter's intellectual property rights and confidential information. See also Chapter 18 on the "Law of Intellectual Property Rights" and Chapter 19 on "Intellectual Property Licensing."

A distribution contract with a distributor in a country with evergreen statutes (see section below on commercial agency) that protect employees and commercial agents at the time of termination should include not only an independent contractor clause, but also a **no-agency-non-partnership clause**. Such a clause characterizes the distribution relationship as simply one between a seller and a buyer. Furthermore, the contract does not create an implied partnership or joint venture between the parties. To support this characterization the contract should allocate to the distributor all matters relating to customer credit, billings, and invoices, and that the risk of non-payment is borne by the distributor. This type of clause seeks to avoid the evergreen protections provided to employees, commercial agents, or distributors.

The duration of the contract should be specified in the contract, along with matters relating to future renewals of the contract. Thus, distribution contracts generally self-terminate at the expiration of the contract term. However, either party may terminate distribution contracts for just cause. It is best to define what would trigger a **just cause termination**. Any type of breach may not be sufficient to justify the termination of the contract. Some courts and arbitration panels make a distinction between a material breach justifying termination and a minor breach leading to a bad faith termination of the contract. From the perspective of the exporter it is best to include a detailed list of events that allow for termination. This list is placed in either the **default or termination clause**. For example, the clause provides that the distributor shall be deemed in default and the exporter has a right of termination upon the occurrence of the following events: (1) distributor ceases to operate or otherwise abandons its business with respect to the sale of exporter's goods; (2) distributor transfers any rights or obligations under the contract to a third party; (3) distributor sells its business or a controlling interest; (4) distributor knowingly maintains false books or records, or knowingly submits any false reports to the exporter; (5) distributor fails to make timely payments for the goods; (6) distributor fails to comply with host country laws and regulations relating to the marketing and selling of exporter's products; and (7) distributor markets or sells similar products of a competitor. The longer and more detailed the list of default events the greater the rights of the exporter to terminate the contract and reasonably argue that the termination was for just cause. Other types of default events include cases where the distributor files for bankruptcy or becomes insolvent or if it fails to meet required sales thresholds or quotas.

Protection of IPR, Trade Secrets, and Confidential Information

It is especially important in international distribution contracts to provide for the protection of intellectual property rights (IPR), trade secrets, and know-how. A common clause is called the **non-challenge or validity clause**, which prohibits the distributor from challenging the validity of the manufacturer-exporter's IPR. For example, a patent or copyright recognized under the country of the exporter may not be enforceable under some foreign laws. The distributor could challenge the validity of the patents and copyrights in its home country. If they are not valid, then there is no reason for the distributor to pay fees or royalties for their use. Even more problematic for the exporter is when a distributor registers for ownership of the patent or copyright in the countries covered by the distribution contracts.

The exporter will want to protect its trademarks by requiring that its products and relevant packaging sold by the distributor display all necessary trademarks. The contract should require that the distributor not alter or add to such trade names, trademarks, labels or literature in any way, and not do any act which might injure or dilute, diminish or otherwise adversely affect the reputation of the exporter and its products. **Dilution of trademark** is a technical term that is discussed in Chapter 18. The contract should also make clear that trademarks and brand names are the exclusive property of the exporter, and that any rights in any new trademarks or copyrights related to the products, such as a new slogan, developed by the distributor shall be assigned to the exporter.

The manufacturer-exporter should carefully state in the contract the IPR and confidential information being licensed or shared with the distributor. This description is accompanied by a **reservation of rights clause** that states that any rights not expressly granted to the distributor remain with the exporter. Often the rights given to use such information and know-how are provided on a royalty-free, nonexclusive basis, but for the sole purpose of selling or distributing the exporter's products. The exporter will also want to control how the distributor markets its products

by requiring that any sales, advertising, promotional, or related materials directed to the ultimate consumers receive the exporter's prior written approval.

As noted previously, a **confidentiality clause** in the contract should state that the obligations continue after the termination of the contract. The distributor must maintain the confidentiality of the exporter's trade secrets indefinitely after the termination of the distribution contract, except in the cases where the confidential information becomes part of the **public domain**. In order to prevent the distributor from using the exporter's information or know-how to promote a competitor's products, even if not intentionally, the exporter may consider including a prohibition that the distributor shall not manufacture, sell, or distribute any product that is similar to exporter's products for a period of years following the termination of the relationship. However, such a provision may not be enforceable under foreign competition (antitrust) law, which is the subject of the next section.

Public domain refers to information, images, and creative works that have become part of public information and are freely useable. For example: previously protected intellectual property rights that have expired or have been forfeited; trade secrets that have been leaked or reverse engineered become part of the public domain.

Foreign Competition Law

Most distribution agreements provide exclusive territories to the distributor; the exporter may be prohibited from selling products to customers who are likely to import them into the distributor's territory and the distributor will be prohibited from selling the products outside of its exclusive territory. The developing countries look with skepticism on any such restrictions and generally will not enforce restrictive contract provisions in their courts. Most developed countries allow the contracting parties full freedom to contract and will enforce most restrictive clauses. Under antitrust or competition laws, some forms of exclusivity may be deemed to be anticompetitive, and certain restrictions will be scrutinized.

EU Regulation 1983/83 deals with the legality of exclusive distribution agreements. For example, it generally disfavors clauses that prohibit a distributor from selling within the territory of another distributor. However, certain **block exemptions** can be utilized to defend against such challenges. A block exemption is simply a statutory recognition that certain types of business practices are to be permitted even though they technically violate EU competition (antitrust) law. An example would be exclusive territories pertaining to automobile dealerships. In addition, foreign competition laws need to be researched to see if exclusivity in a distribution agreement will be enforceable. Because of the complexity of foreign competition law, it is advisable to have a specialist review the distribution agreement.

Price-fixing and **tying clauses** are those most likely to be held as illegal. For example, many national laws prohibit the principal or licensor from setting pricing guidelines, especially at the retail level. Tying clauses that require the distributor to purchase other items along with the licensed product are generally unenforceable. One exception is when tying products or services is needed to ensure the quality of the licensed or distributed product. In such cases, a requirement that the licensee purchase materials from certified suppliers is likely to be enforced.

Noncompetition clauses are also susceptible to nonenforcement. Generally, a distribution contract cannot prohibit the agent or representative from also selling the products of another company. The one major exception is that U.S. courts will allow such clauses in cases involving patented property rights where the distributor is given an exclusive license. Thus, one strategy to increase the chances of enforceability is to tie exclusivity to non-competition. For example, the distributor can be given the right to sell the goods of a competitor but in doing so converts the distribution agreement from exclusive to nonexclusive.

New Trend in Distribution of Goods: "Just in Case"

Just-in-time contracting (JIT) has been a popular supply management system for decades. It is an inventory strategy that companies employ to increase efficiency and decrease waste by receiving goods only as they are needed in the

production process, thereby reducing inventory costs. Just-in-time manufacturing and (JIT) supply developed in Japan in the 1960s, most notably at Toyota.⁵ It eventually became a mainstream method in supply chain management with its adoption by many Western companies in the 1980s. It aims to reduce costs and wastes, such as the costs of warehousing large inventories of supplies or manufactured products. JIT also refers to the ability to quickly respond to changes in the market and the needs of customers and has been tied to **total quality management (TQM)**. JIT and TQM are interconnected since JIT depends on making it right the first time (avoidance of defective goods) and on preventive maintenance to avoid shutdowns and disruptions in the supply chain.

Total Quality Management (TQM): After working with industries in Japan after World War II, W. Edwards Deming returned to the U.S. and started the TQM movement. The main insight is that by consistently looking at lowering costs, manufacturers inevitably lowered the quality of their products. The International Standards Organization (ISO) defines TQM as:

“A management approach of an organisation centred on quality, based on the participation of all its members and aiming at long term success through customer satisfaction and benefits to all members of the organisation and society.”

However, there are inevitable disruptions in the supply chain, such as those due to natural disasters. An example was the closing of the ports in New York and New Jersey because of Hurricane Sandy in 2012. Even before Sandy, some companies modified their JIT approach by moving to a **“just-in-case” distribution** system.⁶ It is interesting to see how thinking changes and ideas are recycled. For many years, companies went to centralized distribution centers by reducing the number of their warehouses and manufacturing plants in order to reduce costs. Just-in-case is based upon bringing the goods closer to the customer, which means increasing the number and strategically placing distribution centers throughout the supplier’s market, which strengthens the supplier’s JIT capabilities. Previously, it was common to warehouse goods at the major ports and ship the goods based on JIT needs throughout the country. More and more companies are now building distribution centers closer to their customers based upon the goal of being able to deliver materials and goods by truck within 24 hours. For example, Amazon.com opened three new distribution centers just in Texas. Increasing the proximity of the goods to customers decreases the chances of disruption in the supply chain and reduces transportation costs. It is generally accepted that the last leg of transporting goods is the most expensive, since the trucks are often nearly empty in delivering a single order. Shortening the distance of the final leg reduces transportation costs. Furthermore, it reduces the competitive advantage of local supply companies by being able to deliver goods just as quickly.

From a law perspective, JIT shifts the risks of untimely delivery from the buyer to the supplier. When entering into a JIT contract a manufacturer-exporter should take added precautions in negotiating the distribution or supply contract. Even though just-in-case supply reduces the risk of delay, JIT still provides a great deal of risk to the exporter-supplier of goods when ocean carriage is used. The *force majeure* clause should be expanded to include additional events that may delay the delivery of the goods, such as a shortage of materials needed to produce the goods. A clause requiring the buyer to maintain a minimum level of inventory alleviates the risk of damages for short-term delays in delivery.

Commercial Agency

The most common use of the agency (independent contractor) vehicle for transacting business is the hiring of a foreign sales representative or commercial agent. This relationship has been defined as the hiring of an agent “to prospect for and visit customers with a view to negotiating and when appropriate concluding sales agreements in the name and for account of the principal (exporter of goods, services, technology).”⁷ Under European Union regulations the mere supplying of marketing services does not fall within the definition of **commercial agency**.⁸ The ICC’s

Commercial Agency—Guide for the Drawing Up of Contracts notes some domestic laws grant special status to the commercial agent.

Therefore, laws of the foreign country of the commercial agent need to be researched “to ensure that nothing contained in a commercial agency contract is repugnant to imperative [mandatory] provisions”⁹ of any law applicable to the contract. Even if the contract is enforceable as written, foreign laws will need to be studied in order to avoid their application to the principal. The clearest example of this is the application of foreign tax liability to the principal. In many countries a nonresident principal will be liable for tax if the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of the principal. For instance, when a principal appoints an agent in a foreign country, with a fixed office therein and with power to make contracts on his behalf, the principal may be deemed to be carrying on business in that foreign country and be taxed accordingly.¹⁰ Clearly the use of foreign counsel is required in order to avoid such liability traps.

Provisions related to the termination of the agreement are the most important part of an international agency contract.¹¹ This is because of the existence of host country laws that restrict a foreign company’s right to terminate an agency agreement. These laws, popularly referred to as **evergreen statutes**, will be dealt with in the next section.

Evergreen Statutes

The most difficult laws to avoid are national agency termination laws, popularly referred to as evergreen statutes. These laws often impose minimum notice requirements for terminating an agent or require the payment of an indemnity upon termination unless the termination is based upon a just cause. These laws are different than the employment regulations discussed earlier in the chapter. Unlike employment regulations, evergreen statutes do apply to agents acting as independent contractors.

Many European countries grant the agent a right upon the termination of the agency relationship to either an indemnity payment, based upon the length of the relationship and the level of past or anticipated payments, or to a claim for *damages* attributed to the termination. In countries like France, a decision not to renew an agency contract is construed as a termination requiring remuneration. **European Union Directive 86/653** provides that agency contracts should provide for a minimum notice of termination. A reasonable notice period is one month per year of service. A commercial agent will be owed an indemnity upon termination to the extent that he has brought new customers to the principal or significantly increased the principal’s volume of business.¹²

Article 17(3) of the EC Directive also allows national laws to provide for a damage claim to the agent, especially if at the time of termination the agent had not completely amortized his costs and expenses relative to the representation. Article 17(5) requires the agent to notify its principal of a claim for indemnity or damages within one year from the date of termination. The best approach is to enter into a fixed term contract with no renewal options. As stated earlier, the contract should provide a detailed list of performance standards upon which termination for *just cause* may be based. Also, some country laws, as in Belgium and France, presume that the agent is an employee even if the contract designates the agent as an independent contractor. Therefore, the easiest way to avoid this presumption is to deal with agents who are artificial entities (corporations). For example, in Belgium if the contract subordinates the agent to the authority of the principal, then there is a legal presumption that an employment relationship has been formed. However, this presumption can be overcome if the agent is a corporate entity.

National labor and employment laws will need to be checked for obligations of the principal pertaining to social security and other “employment-related” statutory requirements. Under Italian law, the principal and the agent must pay 5 percent each on all commissions paid to the national agency (ENASARCO) as social security contributions. The principal is legally obligated to withhold the agent’s contribution and remit it to the agency, along with an amount to be used toward the severance indemnity. A certain percentage is paid on a sliding scale based on the amount of the commissions paid, ranging from 4 percent to 1 percent.

It is vital to include an **escape clause** that allows for the termination of the agency contract with a fixed period of notice. Some contracts specify that either party may terminate the agreement with written advance notice of 30, 60, or 90 days. Some countries require a minimum notice period. Three months satisfies the requirements of many countries. Other contracts specify a certain term for the agreement (usually 1 year) but arrange for automatic annual

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| <ul style="list-style-type: none"> • How far in advance must the representative be notified of the exporter's intention to terminate the agreement? (Three months satisfies the requirements of most countries.) • What is just cause for terminating a representative? (Specifying causes for termination in the written contract usually strengthens the exporter's position; specific causes include the agent's failure to meet a minimum level of sales or a conflict of interest related to agent's sales of a competitor's products.) • Which country's laws will govern a contract dispute (choice of law)? (Courts in some countries will disregard the contract's choice of law clause and apply the laws of the representative or agent nation's legal jurisdiction.) | <ul style="list-style-type: none"> • What compensation is due the representative on dismissal? (Depending on the length of the relationship, the added value of the market the representative has created for the exporter, and how termination for just cause is defined by the foreign country, the exporter may be required to pay damages or an indemnity.) • What must the representative give up if dismissed? (The contract should specify the return of patents, trademarks, name registrations, customer records, promotional, and other confidential materials.) • Should the representative be referred to as an agent? (The contract may need to specify that the representative is not a legal agent with power of attorney.) • In what language should the contract be drafted? (English should be the official language of the contract in most cases.) |
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Figure 17.3 *Doing Business Internationally*: Legal Issues in Drafting Termination Clause.

renewal unless either party gives written notice of its intention not to renew. In some cases, escape clauses and other provisions to safeguard the exporter are limited by evergreen protections afforded to the agent under national law. Because of the existence of these statutes the agency contract should include a default and termination clause in the agreement that allow the exporter or principal to end the relationship for just cause termination, which require little if any advanced notice. The contract should spell out exactly what constitutes *just cause* for ending the agreement. See Figure 17.3 *Doing Business Internationally*: “Legal Issues in Drafting Termination Clause.”

Negotiating a Commercial Agency Contract

The ICC *Guide* can be used as a checklist in order to draft an agency contract. The following summary of the *Guide* illustrates the types of issues and contract terms that an international agency contract should address. Again due to the existence of evergreen states, it is crucial that the agency contract contain an **independent contractor clause** stating that the agent is an independent entity and is not controlled in any way by the exporter. To make clear the independent nature of the relationship the agent should not be an individual, but a legal entity, such as a limited liability company. The title of the agreement should state that it is an independent contractor contract. For a brief review of other important contract terms see Figure 17.4 *Focus on Transactions*: “Key Contract Terms.”

As noted earlier, foreign laws heavily impact the classification of a given relationship as one of employment or independent contracting. Also, once designated as an employment or independent contractor relationship, a number of host country laws regulate areas such as notice, termination, and remuneration. It is important to note that the terminology of agency, employment, and independent contractor as used in the United States often differs in other countries. For example, “the general meaning of *agent* may differ from country-to-country, which emphasizes the need for contractual clarity in defining the relationship.”¹³ It is important to understand the local terminology and factors used in a host country's law before drafting relevant clauses, such as an independent contractor clause. The heading of the agreement should clearly state that it is a commercial agency contract. In order to be absolutely clear as to the intended contractual relationship, the heading and a provision in the contract should state that it is an independent contractor arrangement.

Del credere relationship is generally recognized when the agent guarantees its customer's payments to the principal. The agent acts not only as a salesperson or broker for the principal, but also as a guarantor for the buyer. If the buyer is unable to pay, a *del credere* agent may become liable for the unpaid amount. The contract should explain the extent of the agent's liability.

Assignment: If the parties intend to allow assignment, the contract should state the conditions and procedure for assignments.

Language of the Contract: If the contract is written in two languages, it should state which language is to control in the enforcement of the contract.

Products: The contract should be clear regarding the products that are to be sold on behalf of the principal. If the principal produces different classes of products, then the contract should state which classes are subject to the agency contract.

Agency Territory: The contract should precisely delineate the sales territory that is being given to the agent. A further restriction may be placed upon the sales to third parties who are likely to export the goods to another territory. Such restrictions are needed to prevent the gray market problem discussed in Chapters 18 and 19.

Solicitation of Customers: The parties should agree to the groups to be targeted by the agent as potential customers.

Acceptance of Orders: The agreement should clearly state whether the agent has the authority to bind the principal.

Intellectual Property Rights Infringement: The relative responsibilities of the parties as to infringement of intellectual property rights should be defined. For example, the agent's responsibility to notify the principal of any such infringements should be detailed.

Advertising and Marketing Materials: The contract should stipulate whether the principal is to provide any samples or advertising materials, and which party is to pay the costs of such materials. The contract should make clear whether the principal

has the right of prior consent for any materials or advertising produced by the agent.

Best Efforts Provision: The principal will want to negotiate a clause that requires the agent to use "best efforts" in marketing and selling the principal's products. The agreement should attempt to define the meaning of "best efforts" such as tying them to generally accepted business practices.

Noncompetition Clause: This provision prohibits the agent from selling the products of a competitor.

Parts and Service: The obligations of the agent should be detailed with regard to providing after-sales service and spare parts.

Legal Information: A clause may be inserted that the agent must inform the principal of any changes in national laws or regulations relating to technical requirements, labeling, and customs regulations. This should include information regarding any national requirement to register the agency contract.

Confidentiality: The agreement should require the agent to maintain the secrecy of the principal's trade secrets even after the termination of the relationship.

Minimum Sales: The principal may want to negotiate that the agent is required to meet certain minimum sales levels. It should specify the consequences for the failure to meet sales quotas such as termination, reduction of territory, or loss of exclusivity.

Termination: The contract may be for a fixed period or an indefinite time period subject to reasonable notice. Some national laws require that the notice be of a certain length of time. It may be stipulated that certain events, such as bankruptcy, merger, assignment, resignation of a key employee, give a party the right to terminate.

Figure 17.4 *Focus on Transactions:* Key Contract Terms.

Consulting Contracts

A **foreign consultant** is a variation of the foreign sales representative or commercial agent. The same issues of host country labor laws and agency termination laws apply to the consulting relationship. The **consulting contract** should be specific as to the scope of the engagement, such as for advertising or technology services, and should emphasize the independent status of the consultant. A separate "independent contractor status clause" should be incorporated into the agreement. The factors often utilized in making the distinction between

The main difference between a representative office and an agent is that the former cannot sell or sign contracts but only market and do research, while the latter can perform all trade activities. Only Indonesians can function as agents. Foreign principals often work out a management agreement that allows the foreign company in Indonesia to play a more active role in the marketing efforts of its Indonesian agent or distributor. In many cases, a separate agreement is signed between the expatriate personnel and the foreign employer to regulate this relationship. The tax liability of the foreign firm is limited to the income of the expatriates assigned to the representative office, while any other taxes are assessed to and borne by the agent. Types of management agreements include: (1) technical assistance agreements; (2) management agreements; and (3) management agreements coupled with financial agreements.

The technical assistance agreement limits the foreign firm's function to providing technical assistance to the Indonesian company. The management agreement allows the foreign firm to manage the company or a division within the company. In the management agreement coupled with a financial agreement, the foreign firm also finances the Indonesian operation, either under the name of the Indonesian company or a division thereof. Remuneration to the foreign company can be in one of the following forms: (1) fixed fee; (2) commission; or (3) profit-sharing. Whatever basis is used for remuneration, it must be formulated clearly in the agreement, and it must be applicable under the present Indonesian laws. To protect the foreign company's interests properly, a bona fide and comprehensive agreement should be drawn between the parties concerned.

Figure 17.5 *Doing Business Internationally:* Indonesia Case Study.

employee and independent contractor should be incorporated into this clause, including that the consultant is not an employee; the consultant performs the job based on its own discretion and skills; the consultant is responsible for hiring any subagents or assistants; and the consultant provides its tools, equipment, and materials, and pays its own overhead expenses. The agreement should state that the services are being provided on a nonexclusive basis and that the principal takes no responsibility for the manner in which the consultant performs on the contract. Compensation should be structured to highlight the independent basis of the relationship. For an example of the use of foreign sales representatives and consultants see Figure 17.5 *Doing Business Internationally: “Indonesia Case Study.”*¹⁴

In the negotiation of a commercial agency contract, it is important for the principal (manufacturer) to list detailed reasons or causes for termination including benchmarks or specific tasks that the agent must perform. The *Schuler v. Wickman Machine Tool Sales* case involves a claim for unjust termination of an agency agreement.

L. Schuler AG v. Wickman Machine Tool Sales Ltd.

[1974] AC 235

L. Schuler was a manufacturing company and they granted Wickman the sole right to sell their products in the United Kingdom. In the terms of the agreement, Wickman was to visit six of Schuler’s major British clients each week for the duration of the 4-year contract, which they failed to do. It said in the contract that this was a “condition” of the agreement. Schuler repudiated the contract.

Issue

Does a breach of condition in an agency contract give the principal the right to terminate the contract?

Background

Simply calling something a “condition” in a contract does not itself mean that it’s a breach of contract leading to termination without looking at the surrounding circumstances. In *Hong Kong Fir Shipping Co. Ltd. v. Kawasaki Kisen Kaisha Ltd.*, Lord Diplock stated that the test does not always depend on whether the thing that was breached was a warranty or a condition, as sometimes the circumstances are more complex. The correct test is to look at the events which have occurred as a result of the purported breach and to decide if these events deprived the party attempting to terminate of the benefits that it expected to receive from the contract.

Decision

LORD REID, writing for the majority, states that simply calling something a “condition” does not necessarily make its breach one that entitles a party to a right of

rescission (termination). In this case, it is clear that it would be practically impossible for Wickman to successfully complete all of the visits. There was also another clause in the contract that said Schuler would inform the distributor of material breaches and demand a remedy, which did not occur here.

The House of Lords (now the Supreme Court of the United Kingdom) held by a majority that Schuler was not entitled to terminate, and held that clause 7(b) was not a condition for the contract continuance. Clause 7 was to be read with clause 11, so that notice would need to be given to remedy the situation before clause 7 would lead to a breach. Only after 60 days notice without compliance would termination be allowed. Lord Reid said the following.

Schuler maintains that the use of the word “condition” is in itself enough to establish this intention. No doubt some words used by lawyers do have a rigid inflexible meaning. Use of the word “condition” is an indication, even a strong indication, of the parties’ intention but it is by no means conclusive. The fact that a particular construction leads to a very unreasonable result must be a consideration that the parties did not have that intent. If they did then that intent must be made abundantly clear. In this case, if the parties gave any thought to the idea that one visit per week amounted to 1,400 visits, then they would have realized that some of the visits would be missed for a good reason, such as the illness of the sales representative or a customer being unavailable on a given week. Under Schuler’s contention even one missed visit gave grounds for termination of the contract. This is so unreasonable that it must make me search for some other possible meaning. Clause 11 provides the means for a

reasonable, alternative interpretation. Thus, clause 7 means that only a contractual breach left unremedied can be a basis for the interpretation of the contract. Thus, clause 7 does not mean a single breach, however minor, permitted the party to terminate the whole agreement.

LORD WILBERFORCE dissented, holding that Schuler should have been able to terminate.

Does clause 7 amount to a “condition” or a “term”? My Lords (fellow Justices), I am clear in my own mind that it is a condition, but your Lordships take the contrary view. On a matter of construction (interpretation) of a particular contract, for my part, to call the clause arbitrary, capricious or fantastic, or to introduce as a test of its validity the ubiquitous reasonable man (I do not know, in this case, whether he is English or German) is to assume, contrary to the evidence, that both parties to this contract adopted a standard of easygoing tolerance rather than one of aggressive, insistent punctuality and efficiency. This is not an assumption I am prepared to make, nor do I think myself entitled to impose the former standard upon the parties if their words indicate, as they plainly do, the latter.

Case Highlights

- It is important to be specific in listing causes or types of defaults that trigger the ability of a party to terminate a contract. However, the case shows that the parties should be cautious not to insert a default clause that if literally interpreted would result in an unjust termination.
- The idea that not all breaches trigger a right to terminate was noted by Lord Diplock when he stated that the “correct test is to look at the events, which have occurred as a result of the purported breach and to decide if these events deprived the party attempting to terminate of the benefits that it expected to receive from the contract.”
- The battle between Lord Reid and Lord Wilberforce is centered on different approaches to contract

interpretation with Reid taking a contextual approach and Wilberforce taking a formalistic approach. For Reid, the literal or plain meaning interpretation of not being able to miss one out of 1,400 visits to customers is nonsensical, which leads him in search of an alternative meaning that he finds in clause 11 and the idea of “unremedied” breaches—since Wickman’s missed visits did not cause any damage to Schuler, and follow-up visits remedied the breach, the few non-visits did not give Schuler the right to terminate the agency contract. Wilberforce takes the traditional approach that if the contract language is clear, then the court should ignore the context of the contract and the fact that a clear meaning interpretation would result in an injustice. He begins with using the outdated distinction between a term (not all breaches of a term lead to a right of termination) and a condition (failure of which terminates the contract). He declares that 100 percent performance (making all 1,400 visits) is a condition of the contract. Therefore, the termination was appropriate and that a reasonable person interpretation was inappropriately applied by Lord Reid due to the clarity of the contract language.

What do Lords have to do with law?

The United Kingdom Supreme Court only came into existence on October 1, 2009. Previously, the court resided in the House of Lords, which is the upper house of the UK Parliament. The Judicial Committee of the House of Lords was entrusted with carrying out its judicial duties. Its members were called “Law Lords.” Thus, prior to the creation of the Supreme Court the judges or justices of the high court were called Lords. And yes, female members of the court were also called “Law Lords”!

Chapter Summary

- 1 A manufacturer-exporter who does not want to sell directly to ultimate purchasers (consumers) has a number of choices in the type of foreign presence it elects to use in selling its products abroad. These choices include the foreign sales representative, who may be an employee or an independent contractor; a commercial agent (independent contractor); and a foreign distributor (independent contractor) and it may also elect to sell directly to foreign retailers who then sell to end users. These relationships have different characteristics and legal ramifications, especially in places like the countries of the European Union.

- 2 One of the exporter's most important decisions is to select a commercial agent to act as its representative in a foreign market or to select a distributor to market and sell its products within a foreign territory (locality, country, or countries). The major difference between a commercial agent and a distributor is the former sells the exporter's goods as a representative, with the goods passing directly from the exporter to the customer. The distributor buys the goods on its "own account" and sells directly to the customer, relieving the exporter of the risk of the goods not being able to be resold.
- 3 A variation on the common distributorship arrangement is exporting by consignment. In such a case, the ownership and title remain with the exporter until the goods are sold to the ultimate purchaser, making the exporter a consignor and the distributor a consignee. Since the title remains with the exporter-consignor, the exporter must obtain insurance to protect it against the risk of loss to the goods.
- 4 In selecting a distributor, the exporter will need to review foreign law relating to the foreign party's authority to act as a distributor, foreign competition law relating to territorial restrictions, and evergreen laws relating to the termination of the distributorship.
- 5 Important provisions to be negotiated in a distribution contract include best efforts, products liability, and termination or default clauses, as well as territorial restrictions. The termination or default clause is the most sensitive due to the existence of evergreen laws. In order to avoid the legal liability to pay an indemnity or damages in terminating the contract, a number of techniques should be employed. First, the contract should be for a limited duration and should be able to be terminated at any time with advance notice, usually a minimum of three months. Second, the termination or default clause should list a number of events (nonperformance) that allow the exporter to terminate the contract immediately for just cause.
- 6 Commercial agency is recognized under European Union law as a relationship in which the law should provide protection for commercial agents. European Union Directive 86/653 requires the exporter to give advanced notice of termination, as well as making the exporter liable for indemnity payments or damages.
- 7 A ***del credere* agent** is a commercial agent that guarantees its customer's payments to the principal.
- 8 In distribution and commercial agency relationships, an exporter may have to share sensitive information with the distributor or agent. It will want to protect its intellectual property rights, trade secrets, and confidential information by inserting confidentiality, no-challenge or validity, reservation of rights, and post-contractual obligations clauses into the contract.
- 9 Consulting contracts are, if well written, something less than a commercial agency relationship, where the consultant is an independent contractor, usually hired on a nonexclusive basis for a fixed task or job.
- 10 The *Schuler v. Wickman* case demonstrated the importance of drafting clear but flexible termination or default clauses, as well as the distinction between a condition and a term and contextual versus formalistic interpretation of contracts.

Key Terms

Agent	Customized Market Analysis	Independent Contractor
Agent-Distributor	Default Clause	Clause
Searches (ADS)	<i>Del Credere</i> Agent	Independent Contractor Status
Authority, Actual	Dilution of Trademark	Just Cause Termination
Authority, Apparent	Escape Clause	Just-in-Case Distribution
Best Efforts Clause	EU Regulation 1983/83	Just-in-Time Contracting
Block Exemption	EU Directive 86/653	Key Personnel
Commercial Agency	Evergreen Statute or Law	No-Agency-Non-Partnership
Confidentiality Clause	Foreign Consultant	Clause
Consignee	Goodwill Indemnity	Non-Challenge (Validity) Clause
Consignment	Guide to Drafting	Noncompetition Clause
Consignor	International Distribution	Price-fixing Clause
Consulting Contract	Agreements	Principal

Products Liability Clause	Termination Clause	Tying Clause
Public Domain	Territorial Restrictions	U.S. Commercial
Reservation of Rights Clause	Total Quality Management (TQM)	Service

Chapter Problems

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| <p>1 What are the different characteristics of a foreign representative, consultant, commercial agent, and a distributor? What is the importance of independent contractor status in all these relationships from the perspective of the manufacturer-exporter?</p> <p>2 What are evergreen laws, who do they protect, and what type of protections do they provide?</p> <p>3 Explain and give an example of the difference between a formalistic and a contextual interpretation of a contract term.</p> <p>4 Match the left column with the right column (see answers on the next page):</p> <hr/> <table border="0"> <tr> <td>A Apparent Authority</td> <td>1 EU Regulation 1983/83</td> </tr> <tr> <td>B Trade Secret</td> <td>2 No Plain Meaning</td> </tr> <tr> <td>C Finding a Distributor</td> <td>3 "When Needed" Supply Chain</td> </tr> <tr> <td>D Territorial Restrictions</td> <td>4 Exporter Retains Title</td> </tr> <tr> <td>E Evergreen Law</td> <td>5 No Actual Authority</td> </tr> <tr> <td>F Just-in-Time Contracting</td> <td>6 Agent-Distributor Searches (ADS)</td> </tr> <tr> <td>G Consignment</td> <td>7 EU Directive 86/653</td> </tr> <tr> <td>H Contextual Interpretation</td> <td>8 Termination of Agency</td> </tr> </table> <hr/> | A Apparent Authority | 1 EU Regulation 1983/83 | B Trade Secret | 2 No Plain Meaning | C Finding a Distributor | 3 "When Needed" Supply Chain | D Territorial Restrictions | 4 Exporter Retains Title | E Evergreen Law | 5 No Actual Authority | F Just-in-Time Contracting | 6 Agent-Distributor Searches (ADS) | G Consignment | 7 EU Directive 86/653 | H Contextual Interpretation | 8 Termination of Agency | <p>5 Match the contract clause on the left with the definition on the right (see answers on the next page):</p> <hr/> <table border="0"> <tr> <td>A Best Efforts Clause</td> <td>1 Just Cause Termination</td> </tr> <tr> <td>B Confidentiality Clause</td> <td>2 Competition Law</td> </tr> <tr> <td>C No Challenge Clause</td> <td>3 Passive Sales</td> </tr> <tr> <td>D Default Clause</td> <td>4 Benchmarks for Performance</td> </tr> <tr> <td>E Price-Fixing Clause</td> <td>5 Intellectual Property Rights</td> </tr> <tr> <td>F Reservation of Rights Clause</td> <td>6 Manufacturer Liability</td> </tr> <tr> <td>G Territorial Restrictions</td> <td>7 Perpetual Obligation</td> </tr> <tr> <td>H Products Liability Clause</td> <td>8 IP Rights Reserved by Manufacturer</td> </tr> </table> <hr/> | A Best Efforts Clause | 1 Just Cause Termination | B Confidentiality Clause | 2 Competition Law | C No Challenge Clause | 3 Passive Sales | D Default Clause | 4 Benchmarks for Performance | E Price-Fixing Clause | 5 Intellectual Property Rights | F Reservation of Rights Clause | 6 Manufacturer Liability | G Territorial Restrictions | 7 Perpetual Obligation | H Products Liability Clause | 8 IP Rights Reserved by Manufacturer |
| A Apparent Authority | 1 EU Regulation 1983/83 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| B Trade Secret | 2 No Plain Meaning | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| C Finding a Distributor | 3 "When Needed" Supply Chain | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| D Territorial Restrictions | 4 Exporter Retains Title | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| E Evergreen Law | 5 No Actual Authority | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| F Just-in-Time Contracting | 6 Agent-Distributor Searches (ADS) | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| G Consignment | 7 EU Directive 86/653 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| H Contextual Interpretation | 8 Termination of Agency | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| A Best Efforts Clause | 1 Just Cause Termination | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| B Confidentiality Clause | 2 Competition Law | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| C No Challenge Clause | 3 Passive Sales | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| D Default Clause | 4 Benchmarks for Performance | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| E Price-Fixing Clause | 5 Intellectual Property Rights | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| F Reservation of Rights Clause | 6 Manufacturer Liability | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| G Territorial Restrictions | 7 Perpetual Obligation | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| H Products Liability Clause | 8 IP Rights Reserved by Manufacturer | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

Internet Exercises

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| <p>1 Review the following web site on how to evaluate a foreign distributor: http://www.going-global.com/articles/evaluating_foreign_distributors.htm.</p> <p>2 Review the following web site on how to develop an export strategy: http://www.unzco.com/basic-guide/c4.html.</p> | <p>3 Review the following distribution agreement on file with the Securities and Exchange Commission (SEC): http://www.sec.gov/Archives/edgar/data/1423542/000119312511017025/dex1025.htm.</p> |
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Other Internet Sources

Pick a country that you may want to export or market goods to and review the relevant **Commercial Country**

Guide written by the U.S. Commercial Service at <http://export.gov/ccg/index.asp>.

Choosing a Distributor: <http://www.unzco.com/basicguide/table3.html>.

[Answers to Problem 4: A(5); B(8); C(6); D(1); E(7); F(3); G(4); H(2).]

[Answers to Problem 5: A(4); B(7); C(5); D(1); E(2); F(8); G(3); H(6).]

Notes

- 1 ICC, *Guide to Drafting International Distribution Agreements*, ICC Pub. No. 441 (E) (1988).
- 2 Ibid.
- 3 See EU Directive of July 25, 1985 (Products Liability Directive).
- 4 See Michala Meiselles, *International Commercial Agreements: An Edinburgh Law Guide* (2013).
- 5 U.S. Commercial Service, *A Basic Guide to Exporting* (2015).
- 6 Matt Hudgins, “New Hubs Arise to Serve ‘Just In Case’ Distribution,” *New York Times*, B4 (February 12, 2013).
- 7 ICC, *Commercial Agency—Guide for the Drawing Up of Contracts* 5 (1993).
- 8 See EC Directive 86/653/EEC of December 18, 1986.
- 9 Ibid. note 1, at 6.
- 10 Ibid. at 7.
- 11 The label “agency contract” is broad enough to include a wide variety of contracts including sales representation, distribution, consulting, advertising, and transportation agreements.
- 12 EC Directive 86/653, Article 17(2).
- 13 Ralph Folsom and Michael Gordon, *International Business Transactions* 4, n. 1 (West 1995).
- 14 U.S. State Department’s Country Commercial Guide for Indonesia.



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Part VI

LICENSING AND INTELLECTUAL PROPERTY RIGHTS



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LAW OF INTELLECTUAL PROPERTY RIGHTS

A growing portion of world GDP is reflected in the increased value of intellectual property rights. This chapter reviews the basics of intellectual property law in the U.S. It then reviews intellectual property rights protections found in international and regional conventions and agreements, and reviews a sample of foreign national intellectual property laws. The major intellectual property law regimes include patent, trademark, and copyright. The areas of trade secrets, software, and database protections will also be examined.

In way of introduction brief definitions of the recognized areas of intellectual property will be offered here. **Patent law** protects inventions that are “novel, useful, and non-obvious.” U.S. law lists a number of statutory categories of *patentable* subject matter, including machines, manufactured articles, processes, and compositions of materials. The term trademark includes any word, name, symbol, or device, or any combination used by persons or companies, which they intend to use in commerce to identify and distinguish its goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods. Other than the traditional trademark, **trademark law** also protects other types of distinctive “marks,” including trade dress, service marks, certification marks, collective marks, and geographical indicators (country of origin). A **service mark** is the same as a trademark, except that it identifies and distinguishes the source of a service rather than goods.

Copyright law protects works of original authorship from unauthorized duplication, modification, or distribution. Mere creation of the work results in copyright protection. However, placing a copyright notice on the work and registering it with the Copyright Office provides more complete protection. A **trade secret** is any device or information that is used in a business and gives its owner an advantage over its competitors. Trade secrets law provides for perpetual protection, unless the protected information becomes publicly known.

The next section will review the major tenets of these areas of U.S. law for three purposes: First, to highlight major issues and concepts found in intellectual property protection. Second, in order to compare similar international and foreign laws later in the chapter. Third, the shortcomings of intellectual property laws, especially in the international arena, underscores the importance of transfer and licensing agreements discussed in Chapter 19.

Intellectual Property Rights in the United States

The U.S. provides a wide range of protections for intellectual property, including patents, trademarks, service marks, copyrights, trade secrets, and semiconductor mask works. Many businesses, particularly high-technology firms, publishers, chemical and pharmaceutical firms, recording companies, and computer software companies, depend heavily on these protections. This section will review the four major areas of protection found in U.S. law—trademark, copyright, patent, and trade secrets.

Trademark Protection

A trademark is any word, name, symbol, or device or any combination that identifies goods and distinguishes them from those manufactured or sold by others. Trademarks are derived from their *commercial use* in order to identify goods and are protected by registration and filing at state and federal levels, as well as through international treaties

and conventions. The federal law that deals with trademark issues is the **Lanham Act** or Trademark Act. The Lanham Act prohibits three forms of unfair competition related to trademark infringement: (1) false advertising, (2) passing off (counterfeiting), and (3) false designation of place of origin. The Lanham Act defines *false advertising* as the use of a “false or misleading description of fact, or false or misleading representation of fact in commercial advertising or promotion which misrepresents the nature, characteristics, qualities, or geographic origin of his or another person’s goods, services, or commercial activities.”

It is not required that a mark be registered in order to be able to bring a trademark infringement (passing off) or *false designation of origin* claim. In order to prove passing off the plaintiff need prove that there is a likelihood of consumer confusion between the trademarked good or service and the infringer’s good or service. A trademark or service mark registered with the U.S. Patent and Trademark Office remains in force for ten years from the date of registration and may be renewed for successive periods of ten years, provided the mark continues to be used and has not been previously canceled or surrendered. A service mark is a name, phrase, or other device used to identify and distinguish the services of the provider.

To prove trademark infringement under U.S. law, a party must prove that another’s use of the registered mark is likely to confuse consumers regarding the source of the product or service. A number of factors are used to determine the likelihood of confusion, including: (1) degree of similarity between the marks; (2) intent of the alleged infringer; (3) similarity of use of the two products or services; (4) similarity in the marketing of the goods or services; (5) degree of care likely to be exercised by the consumer or purchaser; (6) evidence of actual confusion; and (7) strength of the registered mark.¹

The *Best Cellars Inc. v. Grape Finds at DuPont, Inc.* case explores the above factors used in making the determination of likelihood of confusion. The case involves the application of trademark protection to **trade dress**. Trade dress refers to the general way a product, service, or business is packaged or presented to the public. The case also serves to highlight the distinction between legally protected trademarks and unprotected **generic marks**.

Best Cellars Inc. v. Grape Finds at DuPont, Inc.

90 F. Supp. 2d 431 (SDNY 2000)

Sweet, District Judge. Plaintiff Best Cellars, Inc. (Best Cellars) has moved for a preliminary injunction to enjoin defendants Grape Finds at Dupont from infringing on various intellectual property rights claimed by Best Cellars under the Lanham Act. This action presents difficult issues relating to the law of trade dress protection. The action involves a unique concept, the retail sale of wine by taste, captured and exemplified in the particular trade dress of the Best Cellars stores. It presents the tension between the protection of certain intellectual property and free and open competition.

Best Cellars operates retail wine stores in New York and Seattle. In the early 1990s, it began to think about developing a new kind of retail wine store where people who knew little or nothing about wine could feel as comfortable when shopping as wine connoisseurs, and in which the “wine by style” concept could be implemented. The name “Best Cellars” was coined in 1993. The company spent considerable time before and during the

design phase of the first Best Cellars store refining the wine by style concept.

It eventually reduced the “world of wine” to eight taste categories: sparkling wines, light-, medium-, and full-bodied white wines, light-, medium-, and full-bodied red wines, and dessert wines. Reducing the world of wine to eight taste categories, instead of by grape type and place of origin, demystified wine for casual, non-connoisseur purchasers.

The design for the first Best Cellars retail store—on the Upper East Side in Manhattan—evolved to contain the following elements: (1) For each of the eight taste categories in the Best Cellars system, a corresponding color and a graphic image (an “icon-identifier”) both to evoke and to reinforce the sensory associations of each category. (2) A display bottle for each wine stands upright on a stainless-steel wire pedestal so that the label is viewable by the customer. (3) Under each display bottle, at eye-level, is a “shelf-talker”: an information card providing the name of

the wine, its vintage, a five or six-line description of its taste, the type of grape from which it is made, its place of origin, the foods which the wine would complement, and its price. (4) The racking system, which was patented, is lit from behind, which causes the bottles to glow.

The founder of Grape Finds discovered the Best Cellars New York store, which he has visited numerous times. The Grape Finds store opened in Washington, D.C., on December 3, 1999. The store possessed many similarities to the Best Cellars store. The display is organized according to eight taste categories. As with Best Cellars, Grape Finds assigned to each taste category a corresponding color and icon-identifier. Moreover, lights above the racks are directed down causing them to glow. As in Best Cellars, beneath the racks are storage cabinets, creating the same visual look.

Section 43(a) of the Lanham Act provides in pertinent part that:

Any person who in connection with any goods or services, uses any word, term, name, symbol, or device, or any combination thereof, which is likely to cause confusion, or to deceive as to the affiliation or connection, of such person with another person, shall be liable in a civil action.

Trade dress has a broad meaning, and includes “all elements making up the total visual image by which a product is presented to customers as defined by its overall composition and design, including size, shape, color, texture, and graphics.” For example, the Supreme Court in the *Two Pesos* case found that a Mexican restaurant was entitled to protection under §43(a) for a trade dress consisting of a festive eating atmosphere having interior dining and patio areas decorated with artifacts, bright colors, paintings, and murals.

The public policy rationale for trade dress protection is explained by the Supreme Court as, “protection of trade dress, no less than of trademarks, serves the Lanham Act’s purpose to secure to the owner of the mark the goodwill of his business and to protect the ability of consumers to distinguish among competing producers.” To establish a claim of trade dress infringement under §43(a), a plaintiff must demonstrate (1) “that its trade dress is either inherently distinctive” and (2) “that there is a likelihood of confusion between defendant’s trade dress and plaintiff’s.”

Best Cellars’ Trade Dress Is Inherently Distinctive

Trade dress is classified on a spectrum of increasing distinctiveness as generic, descriptive, suggestive, or fanciful.

Suggestive and fanciful trade dress is deemed inherently distinctive. A descriptive trade dress may be found inherently distinctive if the plaintiff establishes that its mark has acquired a secondary meaning giving it distinctiveness to the consumer. Under this standard, many trade dresses are likely to be found to be inherently distinctive. The Best Cellars stores look like no other wine stores, with its “wall of wine” and color-coded, iconographic wall signs identifying eight taste categories.

Substantial Likelihood of Confusion

Courts generally apply an eight-factor test to determine the likelihood of confusion between the trade dress of two competitors: (1) strength of the plaintiff’s trade dress, (2) similarity between the two trade dresses, (3) proximity of the products in the marketplace, (4) likelihood that the prior owner will bridge the gap between the products, (5) evidence of actual confusion, (6) defendant’s bad faith, (7) quality of defendant’s product, and (8) sophistication of the relevant consumer group. While the factors are meant to be a guide, the inquiry ultimately hinges on whether an ordinarily prudent person would be confused as to the source of the allegedly infringing product.

First, the strength of a trade dress or trademark is measured in terms of its distinctiveness or more precisely, by its tendency to identify the goods sold as coming from a particular company or source. “Marks that are descriptive are entitled to protection only if they have acquired a ‘secondary meaning’ in the marketplace.” Under this standard, Best Cellars’ trade dress is quite strong. Second, the dominant visual element of both the Best Cellars and the Grape Finds stores is the wall of wine. The evidence demonstrates a significant probability that ordinarily prudent customers will be confused as to the company selling the wine.

Third, “the ‘proximity-of-the-products’ factor concerns the extent the two products compete with each other.” The products here are indisputably similar: value-priced bottles of wine. The class of customers is nearly identical. Fourth, this factor applies when the first user sells its products in one field and the second user sells its products in a closely related field, into which the first user might expand, thereby “bridging the gap.” Here, there is no gap to bridge since Best Cellars and Grape Finds sell the same products in the same field.

Fifth, Best Cellars has presented evidence of actual confusion, but no survey or systematic research was conducted. However, it is black letter law that actual confusion need not be shown to prevail under the Lanham Act, since actual confusion is very difficult to prove and the Act requires only a likelihood of confusion as to source. Sixth, this factor looks to whether the defendant adopted its dress with the intention of capitalizing on plaintiff's reputation and goodwill. Given the evidence of copying of so many aspects of the Best Cellars business, it strains credulity to think that the reproduction of the trade dress—in particular, the “wall of wine”—was not meant to capitalize on the reputation, goodwill, and any confusion between Grape Finds and Best Cellars. Seventh, no evidence has been presented that Grape Finds' products are inferior to those of Best Cellars. This factor therefore favors Grape Finds. Eighth, both stores are specifically targeting the same consumer group—non-sophisticated wine purchasers.

In this case seven of the eight factors weigh in favor of Best Cellars. This is not a case requiring a careful balancing of the factors. Some factors weigh more strongly than others, but there is no doubt that, taken together, Best Cellars has made a substantial showing of a likelihood of confusion between its trade dress and that of Grape Finds. Therefore, it has met the requirements for a preliminary injunction.

Case Highlights

- Trademark law seeks to balance the protection of intellectual property and the need not to deter free and open competition.
- Protection of trade dress is needed to secure to the owner of the mark the goodwill of his business and to protect the ability of consumers to distinguish among competing producers.
- To establish a claim of trade dress infringement, a plaintiff must demonstrate (1) “that its trade dress is either inherently distinctive or that it has acquired distinctiveness through a secondary meaning,” and (2) “that there is a likelihood of confusion between defendant's trade dress and plaintiff's.”
- Generic marks are not entitled to protection under the Lanham Act.
- **Secondary meaning** is the principle that marks that are merely descriptive or generic may still obtain trademark protection if the producer so effectively markets its products with the mark, which consumers come to associate the mark with only that producer. For example, a company markets oranges as “Sunshine Oranges”; if customers come to recognize sunshine oranges as the oranges of that particular company, after five years the company may prohibit others from using the mark “Sunshine” in association with oranges.

Trademark Dilution

On January 16, 1996, the Lanham Act was amended to recognize an infringement claim based upon **trademark dilution**. The **Federal Trademark Dilution Act (FTDA)**² defines dilution as “the lessening of the capacity of a *famous mark* to identify and distinguish goods or services, regardless of the presence or absence of competition between the owner of the famous mark and other parties, or likelihood of confusion.” A trademark dilution claim entitles the trademark owner to an injunction against another person's commercial use of its mark or trade name.

Trademark dilution is defined as dilution by *tarnishment* or dilution by *blurring*.³ The FTDA defines “dilution by blurring” as an association arising from the similarity between a mark or trade name (**junior mark**) and a famous mark (**senior mark**) that impairs the distinctiveness of the famous mark. The following factors are used in determining whether a mark or trade name is likely to cause dilution by blurring: (1) degree of similarity between the mark or trade name and the famous mark; (2) degree of inherent or acquired distinctiveness of the famous mark; (3) extent to which the owner of the famous mark is engaging in substantially exclusive use of the mark; (4) degree of recognition of the famous mark; (5) whether the user of the mark or trade name intended to create an association with the famous mark; and (6) any actual association between the mark or trade name and the famous mark. **Blurring** is a diminishing of the selling power and value of the trademark by unauthorized use. The differences between the senior user (trademark owner) and junior user (alleged infringer) marks are blurred to the extent that individuals are prevented from disassociating the two marks.

The complex questions generated by the intersection of the Internet and copyright or trademark laws are illustrated by *meta-tag* abuse. Internet browsers use search engines to find relevant web sites. For those maintaining web sites, a good listing in a search engine index is crucial for obtaining optimum exposure. The search engines index web sites through the use of HTML (Hypertext Markup Language) source codes. The HTML consists of “markup” symbols or codes inserted in a file intended for display on a world wide web browser. The markup tells the web browser how to display a web site’s words and images for the user. Meta-tags, a portion of this underlying source code, act as signposts that notify the search engines of the content of web sites and facilitate matching search requests to web sites.

Meta-tags are embedded and are not seen by the viewer of the page, but are readable by the search engines. Thus, a party can link itself to a popular web site without overtly using the more popular web site’s name in its URL (Uniform Resource Locator) or web address. Instead, it can embed in its source code keywords taken from the more popular web site. As a result, its web site will be found by a search engine in response to a viewer’s search request for the more popular site. The legal issue is whether this is a type of trademark infringement or dilution covered under U.S. trademark law. The global nature of the Internet indicates that amending U.S. trademark laws to deal directly with meta-tag abuse is unlikely to be totally effective.

Figure 18.1 *Focus on Transactions*: Trademark Dilution and the Internet.

The FTDA defines “dilution by tarnishment” as an association arising from the similarity between a mark or trade name and a famous mark that harms the reputation of the famous mark. **Tarnishment** generally arises when the trademark is linked to products of shoddy quality or is portrayed in an unsavory context likely to evoke unflattering connotations about the product or service.

The junior mark or user is the party accused of trademark infringement or dilution. The senior or *famous mark* or user refers to the trademark owner that brings the claim of infringement or dilution. A new source of trademark infringement and dilution claims involves the Internet and e-commerce. The FDTA sets forth a number of factors to consider in determining whether a trademark is a “famous” one, including degree of distinctiveness of the mark, duration and extent of use of the mark, duration and extent of advertising of the mark, geographical extent of the trading area in which the mark is used, and the degree of recognition of the mark in trading areas used by the mark’s owner and the person against whom the injunction is sought.

The application of trademark law to the Internet will be examined in Chapter 21. For now, see Figure 18.1 *Focus on Transactions*: “Trademark Dilution and the Internet,” which provides one example of the intersection between trademark law and the Internet. It discusses the abuse of **meta-tags** to divert web searchers to web sites unrelated to a famous name or trademark.

Copyright Protection

Copyright is a form of protection provided to authors of “original works of authorship” fixed in a **tangible form** of expression. Copyright has become increasingly important with the development of digital technology and the Internet, where it is a major form of intellectual property protection for content distributed online, and where it faces difficult enforcement issues. Works must be fixed in tangible form in order to receive federal copyright protection; improvisational speeches or performances that have not been recorded or written are not protected. The eight generic categories of copyrightable works include literary, dramatic, musical, choreographic, pictorial (including graphic and sculptural works), motion pictures, sound recordings, and architectural works. These categories are interpreted broadly. For example, computer programs may be registered as “literary works.” Copyright protection is available to both published and unpublished works and affixes to the work at the time of its creation. A copyright, as a general rule, has a term that endures for the author’s life plus an additional 70 years after the author’s death. In the case of works made for hire (owned by a business), the duration of the copyright lasts between 95 and 120 years.

Section 106 of the **Copyright Act of 1976** gives the copyright owner the exclusive *right to reproduce* the work in copies; to prepare derivative works; to distribute copies by sale, rental, lease, or lending; and to perform or display the work publicly. It is illegal for anyone to violate any of these rights. However, the rights are not unlimited. Sections 107 through 121 of the Copyright Act provide a number of exemptions from copyright liability. There are

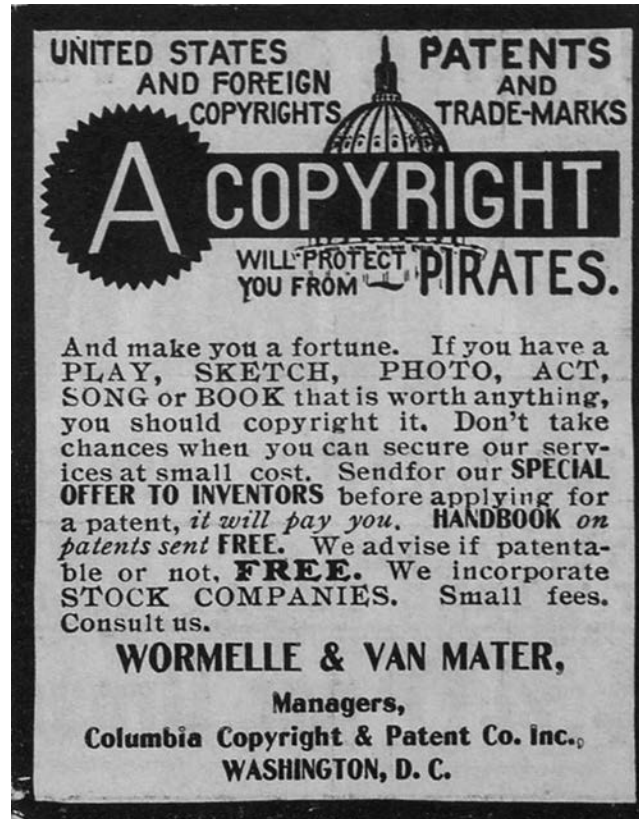


Image 18.1 Copyright Pirate Poster.

Source: Advertisement from the *New York Clipper*, 1906; obtained from the Library of Congress (Author: Columbia Copyright Office).

four general exceptions to the exclusive rights of copyright ownership: (1) first sale doctrine, (2) fair use doctrine, (3) materials that have entered the public domain, and (4) work for hire. See Figure 18.2 *Focus on Transactions*: “Four Exemptions to Copyright Liability.”

The **first sale doctrine** terminates the copyright owner’s protections over a copy of the copyrighted work once the work is legally sold. The purchaser gains the right to resell the copy.⁴ The Copyright Act states that the owner of a copy is entitled to resell the copy without the consent of the copyright owner.

Section 107 of the Copyright Act allows for certain “fair uses” of copyrighted material without the need to obtain the consent of the copyrighted owner. The **fair use doctrine** allows others to use small portions of a copyrighted work in the creation of another work. The most common contexts include in connection with a criticism of the work, in the course of news reporting, for teaching purposes, and as part of scholarship or research activities. The factors analyzed to determine fair use include the purpose or character of the use, such as whether it was of a commercial nature versus for non-profit or educational purposes. The courts will also look at the amount of the use in relation to the copyrighted work as a whole and the effect of the use upon the value or market of the copyrighted work.

Material found in the **public domain** is not protected. These materials include government publications and materials whose copyrights have expired. An analogous concept in trademark law is the brand name–generic distinction. A brand name can be protected as a trademark. However, if the name is used widely as a generic name, then it is said to have entered the public domain and is no longer entitled to trademark protection.

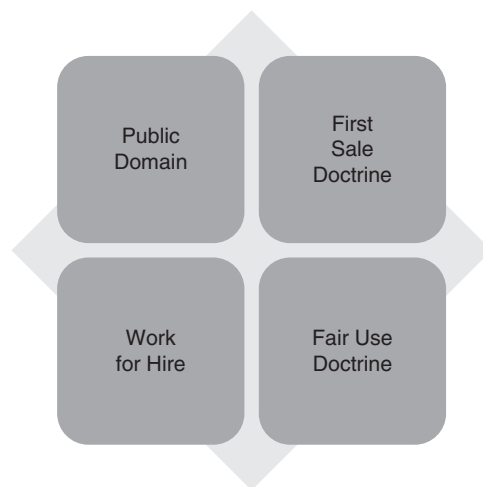


Figure 18.2 *Focus on Transactions*: Four Exemptions to Copyright Liability.

Authorship of a copyrighted work determines who holds the copyright. A work created by an individual vests copyright ownership in that individual automatically upon its creation. **Work for hire** is the major exception. Section 101 of the Copyright Act of 1976 contains a two-pronged test to determine if a work is for hire. First, a work prepared by an employee or a third party within the scope of her employment or within the scope of a contract for hire. The Supreme Court in *Community for Creative Non-Violence (CCNV) v. Reid*⁵ listed 13 factors to be used to determine when a third party who is not a regular employee can be considered an “employee” for purposes of copyright ownership (see Figure 18.3 *Focus on Transactions*: “*CCNV v. Reid* Factors for ‘Copyright Employee’”).

Second, a work is for hire is one which was specifically ordered or commissioned for use as a contribution to a collective work or as part of a compilation. The person for whom the work was prepared is considered the author for copyright purposes. In the case of contributions to **collective works**, the contributor of the work retains a copyright for his part, but the creator or producer of the collective work obtains a copyright to the collective work.

Copyright protection is available for all unpublished works, regardless of the nationality of the author. Published works are eligible for copyright protection in the U.S. if any of the following conditions are met. First, on the date of first publication, one of the authors is a national or is domiciled in the United States. Second, the work is first published in the U.S. or in a foreign country that is a party to an international treaty to which the U.S. is also a party. Third, the work is a sound recording that was first *fixed* in a treaty country.

No publication or registration is required to secure a copyright. The mere act of creation and fixing the work in a tangible form automatically creates the copyright. Publication of the work through distribution of copies, although not required, serves a number of purposes. It is a way of informing the public that the work is protected by copyright. It also provides evidence as to the date of copyright in order to determine the duration of the copyright.

Notice of copyright is no longer necessary when publishing a copyrighted work. Before the 1976 Copyright Act, the law did require the use of a copyright notice when publishing or distributing a copyrighted work. The notice needed to use the copyright symbol, give the year of first publication, and name the owner of the copyright. A standard notice looked as follows: © Jane Doe 2001. In 1989, the notice requirement was eliminated when the U.S. adhered to the **Berne Convention**. Notice is still recommended, however, because it removes the infringer’s defense of **innocent infringement**. Under the innocent infringement defense, the infringer is absolved of liability if she can prove that she did not know the work was protected.

Registration of a copyright with the Copyright Office in Washington, D.C. is not a condition for protection, but registration does provide a number of benefits. First, registration of a copyright establishes a public record. A public record will help the owner prove his claim in future infringement or ownership disputes.

<ul style="list-style-type: none"> • hiring party's control over the means and manner by which the work is accomplished • level of skill required • source of the instrumentalities and tools used in creating the work • location of the work • duration of the relationship between the parties • whether the hiring party has the right to assign additional projects to the hired party • extent of the hired party's discretion over when and how long to work 	<ul style="list-style-type: none"> • method of payment • hired party's role in hiring and paying assistants • whether the work is part of the regular business of the hiring party • whether the hiring party is in business • provision of employee benefits • tax treatment of the hired party <p>This is not considered to be an exhaustive list and no one factor is considered to be determinative.</p>
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Figure 18.3 Focus on Transactions: CCNV v. Reid Factors for "Copyright Employee."

Registration establishes a *prima facie* case of the validity of the copyright and the facts stated in the registration certificate. Second, registration makes available statutory damages and the ability to recover attorney's fees, while at common law the copyright owner is limited to actual damages. Third, registration allows the copyright owner to record a duplicate registration with the U.S. Customs Service for protection against the importation of infringing or counterfeit copies.

Software Piracy

Types of software piracy include: (1) end-user piracy (users copy software for distribution in violation of their software license); (2) preinstalled piracy (computer manufacturer illegally installs software on numerous computers); (3) Internet piracy (copies are illegally downloaded and distributed); (4) counterfeiting (illegal copies are manufactured and distributed, and can include counterfeit packages and registration cards); and (5) online auction piracy (software resold that was marked "not for resale"). The **Business Software Alliance (BSA)**⁶ is a trade group established in 1988 that represents a number of the world's largest software makers and is a member of the International Intellectual Property Alliance. Its principal activity is trying to stop copyright infringement of software produced by its members. The BSA, and other nongovernmental organizations (NGOs) such as the International Anti-Counterfeiting Coalition (IACC), lobby governments to toughen and enforce their antipiracy laws.

Patent Protection

To achieve patent protection, an invention generally must be of practical use (utility), show an element of novelty, and must have been non-obvious (some new application not known in the body of existing knowledge in its technical field). This body of existing knowledge is called *prior art*. The invention must show an inventive step (one that could not be deduced by a person with average knowledge of the technical field). Finally, its subject matter must be accepted as "patentable" under law. In many countries, scientific theories, mathematical methods, plant or animal varieties, discoveries of natural substances, commercial methods, and methods for medical treatment are generally not patentable. See Figure 18.4 *Focus on Transactions*: "Four Requirements to Obtain a Patent."

It is important to file a patent application before you publicly disclose the details of your invention. In general, any invention that is made public before an application has been filed would be considered prior art. In countries that apply the foregoing definition of prior art, the applicant's public disclosure of the invention before filing a patent application would prevent him or her from obtaining a valid patent for that invention, since the novelty requirement would not have been met.

U.S. patent law confers on the patent owner the exclusive rights to manufacture, use, and sell the patented product or process within the U.S. for a period of 20 years. In order to be fully protected, the patent holder or

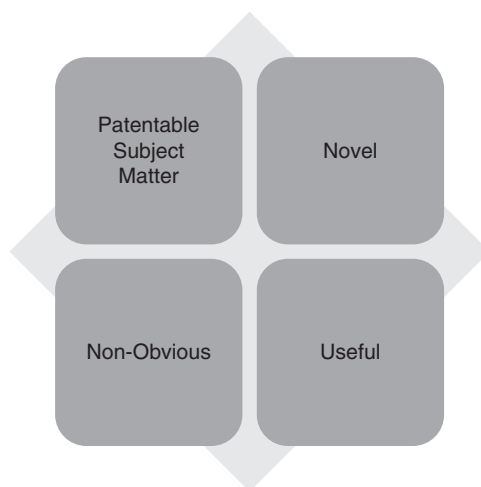


Figure 18.4 Focus on Transactions: Four Requirements to Obtain a Patent.

patentee should serve notice by affixing the word “patent” or the abbreviation “pat.” together with the number of the patent to the patented item or product. The Patent Act defines an infringer as “whoever without authority makes, uses, offers to sell, or sells any patented invention, within the U.S. or *imports* into the U.S. any patented invention.” Furthermore, anyone who falsely marks goods with the name of the patentee “with the intent of counterfeiting or of deceiving the public” is liable for damages.

America Invents Act of 2011: The goal of amending American patent law was to harmonize U.S. patent laws with other systems around the world. The significant provisions include (i) changing to a first-inventor-to-file standard, (ii) creating a prior user right, (iii) expanding the content allowed for prior art submissions during examination, and (iv) creating several new post-grant proceedings for challenging patents before the newly created Patent Trial and Appeal Board (PTAB). The AIA applications are also subject to an opposition-like proceeding called post-grant review (PGR) within the first nine months after issuance of a patent.

Under the **doctrine of equivalents**, there need not be an exact copying of an invention to prove a case of patent infringement. The patent owner has to show only that there is “equivalence” between the elements of the patented invention and the infringing product. However, if the second invention is an improvement of the first then the patent owner is not likely to benefit from the doctrine of equivalents. The doctrine of equivalents also applies to trademarks. In *Enrique Bernat F., S.A. v. Guadalajara, Inc.*,⁷ the seller of “Chupa Chups” sued the seller of “Chupa Gurts” for trademark infringement. Dulces Vero USA sold frozen yogurt cone-shaped lollipops under the name “Chupa Gurts.” Chupa Chups, a Spanish company that sells “Chupa Chups” which are ice cream-flavored lollipops, sued it for trademark infringement. The appeals court held that there was no infringement because the key term, *chupa*, is a generic Spanish word. Under the *foreign equivalents doctrine*, courts translate foreign words used as trademarks into their common English meaning in usage to test them for their generic or descriptive meaning. The word *chupa* is a generic Spanish word for lollipop or sucker, so it is due no protection. The court held that there was no likelihood of confusion.

In *Warner-Jenkinson Co. v. Hilton Davis Chemical*,⁸ the patent owner had developed a process to remove impurities from commercial dyes. Its process operated at pH levels between 6.0 and 9.0. It sought an injunction against the developer of a purification process that worked at a pH of 5.0. The Supreme Court held that the doctrine

of equivalents must be applied to the individual elements of the invention or process and not just the invention as a whole. The fact that both parties had developed a process for the purification of dye did not make them equivalent inventions. Instead, it needed to be determined whether a process that operates at a pH level of 5.0 is equivalent to one that works at 6.0. If the two processes were of equivalent quality, then the owner of the first process was entitled to an injunction under the doctrine of equivalents. If a process that works at a lower pH is qualitatively better, then it is to be considered an improvement and, as such, would be protected as a new invention.

Trade Secrets

Unlike a U.S. patent, a trade secret does not entitle its owner to a government-sanctioned monopoly of its invention for a particular length of time. Nevertheless, trade secrets are protected under state law and through private contracts. Trade secret protection is a product of state common law, although many states have adopted the **Uniform Trade Secrets Act**. The Uniform Trade Secrets Act is a model law that prohibits the misappropriation of trade secrets by theft, bribery, or misrepresentation. Companies protect their trade secrets through confidentiality agreements between them and their employees and by trade secret licensing agreements that prohibit disclosure by licensees.

Recent developments in the area of trade secret law include the passage of the **Economic Espionage Act of 1996 (EEA)**⁹ and the designation of customer lists as trade secrets. The EEA makes it a crime to steal not only government secrets but also business trade secrets. One issue recently explored is how to prove a violation of the EEA without first showing that there was a trade secret to be stolen. The court in *U.S. v. Hsu*¹⁰ held that defendants in a criminal case involving conspiracy to steal trade secrets in violation of the EEA do not have a right to see the trade secrets in question in an effort to prove that there were in fact no trade secrets needing protection. In that case, Hsu and others were indicted for violating the EEA by conspiring to steal corporate trade secrets regarding a valuable anti-cancer drug. The defense maintained that constitutional and procedural requirements of criminal prosecutions dictate full access to the documents so they could establish the defense of legal impossibility (they could not steal trade secrets that did not exist). The court ruled that so long as the defendants believed they were stealing trade secrets, it does not have to be proven that there were actually trade secrets to be stolen.

The issue of protecting customer lists as trade secrets was recently examined in *Nowogroski Insurance, Inc. v. Rucker*.¹¹ The court held that valuable customer lists or databases, which had been reasonably protected by an employer, were protected under the Uniform Trade Secrets Act. An insurance agency sued three former employees for soliciting its clients after they went to work for a competitor by using confidential information. The fact that written forms of the list had not been taken or copied was held to be immaterial. It is the nature of the employment relationship that imposes a duty on employees and former employees not to use or disclose the employer's trade secrets. A valuable customer list, which has been protected by an employer, is due trade secret protection.

Extraterritorial Application of U.S. Law

The Lanham Act allows for a claim for false designations of origin.¹² Section 43(a) makes it illegal for any person to "affix, apply, or annex, or use in connection with any goods or services, or any container or containers for goods, a false designation of origin, or any false description or representation, including words or other symbols tending falsely to describe or represent the same."¹³ The Court of Appeals in *Scotch Whisky Assoc. v. Barton Distilling*¹⁴ held that the Lanham Act could be applied extraterritorially where a U.S. producer supplies false labels to a foreign licensee. In that case, the U.S. company supplied labels designating the product as "Scotch Whisky" to a Panamanian licensee. There was no evidence that the whisky was imported into the United States. Nonetheless, the court held that the Lanham Act applied to the U.S. defendant stating that "no principle of international law bars the U.S. from governing the conduct of its own citizens."

The court in *Scotch Whisky* relied on the Supreme Court decision in *Steele v. Bulova Watches*.¹⁵ In that case, a U.S. citizen registered the Bulova name in Mexico. He then manufactured watches, using the Bulova name

(associated with Swiss company), for sale in Mexico. There was evidence that some of the watches had been imported into the United States. The Supreme Court broadly defined “commerce” in the Lanham Act to include activities of U.S. citizens outside of the country. The court in *Scotch Whisky* held that “the purpose underlying the Lanham Act, to make actionable the deceptive use of false designations of origin, should not be evaded by the simple device of selecting a foreign license.”

The Gray Market

The importation of counterfeit goods is prohibited under the Lanham Act and the Tariff Act.¹⁶ The two pertinent sections of the Lanham Act that apply to the area of counterfeit or pirated goods are Sections 32 and 43(a).¹⁷ They make it illegal to falsely affix another’s trademark to goods or use an improper place of origin designation. The Customs Service is authorized to seize such goods at the point of entry into the country. In order to assist the Customs Service, trademark and copyright owners should *record* their rights with the Service. Section 133 sets forth the procedures governing recording trademarks with the Customs Service. The Customs Service has established an Intellectual Property Rights Branch to administer the intellectual property components of the U.S. import laws.

The so-called **gray market** problem refers to imports bearing a genuine trademark but imported by a party other than the trademark holder or authorized importer. Also referred to as *parallel imports*, they include goods produced outside the U.S. pursuant to an intellectual transfer or licensing agreement, as well as goods licensed in the U.S. for export that are subsequently reimported. In these instances, a U.S. licensor will find its own market territory undercut by identical goods produced under a foreign licensing agreement. The firm that is hurt by gray market imports will often seek to prevent their importation. Section 526 of the Tariff Act provides relief under the first gray market scenario if the license agreement prohibits such importation. The importance of placing such restrictions in international licensing agreements to prevent a gray market problem will be examined closely in the next chapter.

In general, trademark law generally does not reach the sale of goods legally produced outside the U.S. and subsequently imported to compete against the same goods produced domestically. This was the situation in *NEC Electronics v. Cal Circuit Abco*.¹⁸ In that case, the defendant had purchased gray market semiconductor chips from a foreign source and imported them to compete against the trademark owner’s subsidiary. The court held that the onus is on the licensor to provide safeguards in its foreign licensing agreements to diminish the chances of parallel importing.

NEC Electronics v. Cal Circuit Abco

810 F.2d 1506 (9th Cir. 1987)

Sneed, Circuit Judge. A Japanese manufacturer of computer chips, NEC-Japan, assigned its U.S. trademark rights to its California subsidiary, NEC-USA. Defendant, CAL Circuit Abco (Abco), engages in “parallel importation” of NEC-Japan’s chips: it buys them abroad at lower prices and then imports and sells them in the U.S. NEC-USA sued for trademark infringement under the Lanham Act.

In 1983, NEC-Japan, owner of the trademark “NEC” assigned all rights to the mark in the U.S. to NEC-USA, and duly registered this assignment with the U.S. Patent and Trademark Office. NEC-Japan continues to market its computer chips outside the U.S. at prices substantially

lower than those charged by NEC-USA. Defendant Abco buys these so-called “gray market” chips from a foreign source, imports them, and sells them in the U.S. in direct competition with NEC-USA. The parties have stipulated that Abco’s chips are genuine NEC products. NEC-USA sued Abco for trademark infringement under the Lanham Act. NEC-USA alleges that Abco’s use of the “NEC” trademark confuses consumers who believe that Abco’s sales are authorized by or connected to NEC-USA.

Section 32 of the Lanham Act provides the registered owner of a trademark with an action against anyone who without its consent uses a “reproduction, counterfeit, copy, or colorable imitation” of the mark in such a way as

“is likely to cause confusion or to deceive.” Similarly, section 43(a) provides for civil liability if goods are marketed bearing “a false designation of origin.” Trademark law generally does not reach the sale of genuine goods bearing a true mark even though such sale is without the mark owner’s consent. Once a trademark owner sells his product, the buyer ordinarily may resell the product under the original mark without incurring any trademark liability.

Because NEC-Japan and NEC-USA are commonly controlled, there is no danger to the latter in being unable to control the quality of the former’s products. If, as NEC-USA alleges, Abco sales agents mislead their buyers about the availability of NEC-USA servicing, then Abco may be liable in contract or tort, but not in trademark. If NEC-Japan chooses to sell abroad at lower prices than those it could obtain for the identical product here, that is its business. In doing so, however, it cannot look to U.S.

trademark law to insulate the American market or to vitiate the effects of international trade. This country’s trademark law does not offer NEC-Japan a vehicle for establishing a worldwide discriminatory pricing scheme simply through the expedient of setting up an American subsidiary with nominal title to its mark. The preliminary injunction is VACATED.

Case Highlights

- Once a trademark owner sells its product, the buyer ordinarily may resell the product under the original mark without incurring any trademark law liability.
- If a company sells a good more cheaply in a foreign market or licenses someone who does so, the company cannot look to trademark law to prevent the importation of such legally produced foreign goods into its domestic market.

The first sale doctrine, highlighted in *NEC Electronics*, protects the importer of trademarked products from an infringement action if the goods were purchased from or produced by a licensee of the goods. In *Quality King Distributors, Inc. v. L’anza Research International, Inc.*,¹⁹ the Supreme Court held that under the first sale doctrine the owner of copyrighted material is also entitled, without permission of the copyright owner, to sell or otherwise dispose of purchased copyrighted materials, imported or not. The domestic owner of the copyright had entered into a distribution agreement with an English distributor. The distributor sold large quantities of the goods to the defendant–importer, who resold them at discount prices to unauthorized retailers in the U.S. The Supreme Court held that there was no infringement and resale could not be prevented. The *Columbia Broadcasting System, Inc. v. Scorpio Music Distributors* case further examines the first sale defense. In that case, the scope of the first sale doctrine was narrowed in relation to the importation of foreign made records.

Columbia Broadcasting System, Inc. v. Scorpio Music Distributors

569 F. Supp. 47 (E.D. Pa. 1983)

Green, Judge. Plaintiff, Columbia Broadcasting System, Inc. (CBS), is a New York corporation which owns U.S. copyrights to six sound recordings, copies of which comprise the subject matter of this copyright infringement case. CBS-Sony, Inc., a Japanese corporation, entered into two written agreements with Vicor Music Corporation (Vicor), a Philippines corporation, by which Vicor was authorized to manufacture and sell certain phonorecords exclusively in the Philippines. Subsequently, CBS-Sony severed its manufacturing and licensing agreements with Vicor. CBS-Sony and Vicor agreed that Vicor would have sixty days following termination of the agreements within which to liquidate its stock. International Traders bought the phonorecords

from Rainbow Music, Inc., a Philippines corporation, which had purchased them from Vicor before Vicor’s sixty-day selloff period expired.

CBS filed a complaint alleging that without its consent, Scorpio imported the records to which CBS owns the copyrights and thereby violated § 602 of the Copyright Act which prohibits the importation of records without consent of the copyright owner. Scorpio argues that, since the recordings were the subjects of a valid first sale from Vicor to Rainbow Music, defendant has not infringed any of CBS’ rights. When a work is the subject of a valid first sale, the distribution rights of the copyright owner are extinguished, and title passes to the buyer. Scorpio also

argues that it is not an importer under the Copyright Act. However, the question whether defendant was the importer need not be resolved, in view of the law regarding vicarious and contributory infringement and the undisputed fact that International Traders was an importer. Intent is not a necessary element of infringement, and the copyright holder may proceed against any member in the chain of distribution.

Defendant argues that the exclusive rights of a copyright owner, including the right to distribute, are limited by § 109(a), which provides that “the owner of a particular copy or phonorecord lawfully is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy.” This section grants first sale protection to third-party buyers of copies that have been legally manufactured and sold within the U.S. and not to purchasers of imports such as are involved here. Moreover, declaring legal the act of purchasing from a U.S. importer who does not deal directly with a foreign manufacturer, but who buys recordings that have been liquidated overseas, would undermine the purpose of the statute. The copyright owner would be unable to exercise control over copies of the

work that entered the American market in competition with copies lawfully manufactured and distributed under this title. This court cannot construe the statute so as to alter the intent of Congress, which has set restrictions on the importation of phonorecords in order that rights of U.S. copyright owners can be preserved. Accordingly, the defendant’s motion to dismiss is DENIED.

Case Highlights

- Generally, when a work is the subject of a valid first sale, the distribution rights of the copyright owner are extinguished.
- Section 602 of the Copyright Act prohibits the importation of phonorecords without consent of the copyright owner.
- Intent is not a necessary element of infringement, and the copyright holder may proceed against any member in the chain of distribution.
- “First sale” protection is available to the third-party buyer of copies of phonorecords that have been legally manufactured and sold within the U.S. but not to purchasers of imports.

As shown in the *Columbia Broadcasting System* case, there is a history of special statutory protection for music and musical performances. Musicians or performers may enjoy copyright or copyright-like protection in three things. First, a musical composition itself has been protected by statute under copyright law since 1831. Second, the **Sound Recording Act of 1971** extended copyright protection to sound recordings. This means that persons who make unauthorized reproductions of records or tapes can be prosecuted or face civil liability for copyright infringement. Piracy is an unauthorized duplication of a performance already reduced to a sound recording and commercially released. Third, the 1994 **Anti-Bootlegging Statute**²⁰ criminalizes the unauthorized recording, transmission to the public, and the sale or distribution of or traffic in unauthorized recordings of live musical performances. Bootlegging is distinct from piracy; the former deals with commercially unreleased performances and the latter deals with duplication of commercially released recordings.

Enforcement of Intellectual Property Rights

After intellectual property owners secure rights in foreign markets, enforcement must be pursued diligently through local law. As a general matter, intellectual property rights are private rights to be enforced by the owner. Enforcement varies from country to country and depends on such factors as the attitude of local officials, substantive requirements of the law, and court procedures. The availability of criminal penalties for infringement, either as the exclusive remedy or in addition to private suits, also varies among countries. U.S. law affords a civil remedy for infringement, including money damages to a successful plaintiff and criminal penalties for more serious offenses.

U.S. exporters with intellectual property concerns should develop a comprehensive strategy for protecting their property. First, they should obtain the available protection provided under U.S. laws covering inventions, trademarks, service marks, copyrights, and semiconductor mask works. Second, before entering into a licensing agreement with a foreign party, licensors should research the intellectual property laws of countries where prospective foreign licensees conduct business. Third, the services of foreign legal counsel should be engaged to file

appropriate patent, trademark, or copyright applications or registrations within priority periods afforded under international conventions. Fourth, entering the foreign licensing agreement should be viewed as only the beginning of the process. The use of licensed rights should be monitored for abuse and infringement. The licensor should be prepared to act promptly to protect its rights in case of a foreign infringement. Finally, trade secrets should be protected through appropriate confidentiality provisions in employment, licensing, marketing, distribution, and joint venture agreements.

The importance of utilizing all the sources of intellectual property protection is illustrated in the *Carell v. Shubert Organization, Inc.* case that follows. The case involves a claim of copyright infringement. Note that in the opinion reference is made to domestic, foreign, and international copyright laws.

Carell v. Shubert Organization, Inc.

2000 U.S. Dist. LEXIS 8807 (S.D.N.Y. 2000)

Schwartz, District Judge. This action arises out of a dispute concerning the copyright in certain makeup designs created for the cast of the Broadway musical *Cats*. Plaintiff Candace Anne Carell filed this action on July 12, 1999, asserting claims for copyright infringement, false designation of origin, antitrust violations, and an accounting for profits, arising out of defendants' use and publication of her Makeup Designs. The show *Cats* is reportedly "the longest running, most financially successful property" in the history of American theater. There have been over 40 productions of the musical in 27 countries. In addition to her claims brought under the U.S. Copyright Act, plaintiff brings infringement claims under several foreign copyright statutes.

In order for a work to be copyrightable, it must be "an original work of authorship"; that is, it must be (i) original and (ii) fixed in a tangible form. 17 U.S.C. § 102(a). Copyright protection for an original work does not extend to "any idea, procedure, process, system, method of operation, concept, principle, or discovery." The Copyright Act provides that ownership "vests initially in the author or authors of the work." There is no disagreement between the parties that the Makeup Designs are copyrightable, or that the creator of such Designs is entitled to protection even if he or she does not apply the makeup to the show's performers' faces. The Designs contain the requisite degree of originality, and are fixed in tangible form on the faces of the actors.

Domestic Infringement Claims

A complaint based on copyright infringement must allege: (1) which original works are the subject of the copyright claim; (2) that the plaintiff owns the copyrights in those works; (3) that the copyrights have been

registered in accordance with the statute; and (4) "by what acts during what time" the defendant infringed the copyright. A certificate of registration from the U.S. Register of Copyrights constitutes *prima facie* evidence of the valid ownership of a copyright, although that presumption of ownership may be rebutted.

Foreign Infringement Claims

Plaintiff asserts her copyright infringement claims not only pursuant to U.S. law but also pursuant to several foreign copyright statutes, specifically those of Australia, Canada, Japan, and the United Kingdom, and pursuant to the Berne Convention for the Protection of Literary and Artistic Works ("Berne Convention"). Several courts and authorities support the exercise of jurisdiction over foreign copyright infringement claims. In *Armstrong v. Virgin Records*, 91 F. Supp. 2d 628 (SDNY 2000), recently decided in this district, plaintiff, a jazz musician, claimed that defendants violated his copyright in a song recorded by the music group Massive Attack in the United Kingdom, and which was thereafter distributed worldwide. He filed claims for copyright infringement under the Copyright Act and under unspecified international copyright laws. The court held that it could entertain plaintiff's claims under international copyright laws on the basis of diversity jurisdiction, and, potentially, on the basis of pendent subject matter jurisdiction to plaintiff's domestic infringement claims.

Other authorities, while acknowledging that extraterritorial jurisdiction under the Copyright Act is prohibited, have asserted that there may be a basis for jurisdiction in cases similar to the instant matter. As Professor Nimmer has explained: "Even if the U.S. Copyright Act is clearly inoperative with respect to acts occurring outside of its

jurisdiction, it does not necessarily follow that American courts are without jurisdiction in such a case. If the plaintiff has a valid cause of action under the copyright laws of a foreign country, and if personal jurisdiction of the defendant can be obtained in an American court, it is arguable that an action may be brought in such court for infringement of a foreign copyright law. This would be on a theory that copyright infringement constitutes a transitory cause of action, and hence, may be adjudicated in the courts of a sovereign other than the one in which the cause of action arose.”

For the reasons set forth above, defendants’ motion to dismiss is denied as to plaintiff’s copyright infringement and Lanham Act claims. SO ORDERED.

Case Highlights

- Makeup designs are copyrightable as “original works of authorship.”
- U.S. copyright law protects works that are “original” and “fixed in a tangible medium.”
- U.S. courts will at time exercise jurisdiction over foreign copyright infringement claims.

International Property Rights Protection

The rights granted under U.S. patent, trademark, or copyright law can be enforced only in the U.S., its territories, and its possessions; they confer no protection in a foreign country. Outside of the U.S., protection is available through international treaties or foreign intellectual property laws. The relevant international treaties establish minimum standards for protection, but individual country laws and practices can and do differ significantly. See Table 18.1 *Doing Business Internationally*: “International and Regional Intellectual Property Laws.”

The **World Intellectual Property Organization (WIPO)** is the official depository of most international intellectual property conventions. WIPO grew out of the 1883 Paris Convention on patents and trademarks and the 1886 Berne Convention on copyrights. Today it serves two main purposes. First, it administers and monitors the enforcement of more than 20 treaties. Second, it promotes the adoption of new intellectual property treaties and conventions. The major international rights conventions and the World Trade Organization’s **Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)** will be reviewed later in this chapter.

Paris Convention and Patent Cooperation Treaty

To secure patent and trademark rights outside the U.S., a company must apply for patents or register trademarks on a country-by-country basis. U.S. individuals and companies are entitled to a **right of priority** and to **national**

Table 18.1 *Doing Business Internationally*: International and Regional Intellectual Property Laws

Law	Description	Number of Countries	U.S. Membership
Berne Convention	Artistic Works	168	YES (1989)
Universal Copyright Convention	Copyright	100	YES (1955)
WIPO Copyright Treaty	Copyright	93	YES (2002)
Paris Convention	Patents and Trademarks	176	YES (1887)
Patent Cooperation Treaty	Patents	148	YES (1978)
Patent Law Treaty	Patents	36	YES (2013)
Trademark Law Treaty	Trademarks	53	YES (2000)
WTO Trade-Related Aspects of Intellectual Property Rights (TRIPS)	Copyright, Trademarks, Geographical Indications, Industrial Designs, Patents, Layout-Designs of Integrated Circuits, Trade Secrets	162	YES (1996)
NAFTA	Copyright, Patents, Trademarks, and Trade Secrets	3	YES (1992)
EU Directives	Copyright, Patents, Trademarks, and Database Protection	28	NO

treatment in the more than 100 countries that are parties to the **Paris Convention for the Protection of Industrial Property (Paris Convention)**. The Paris Convention, first adopted in 1883, is the major international agreement providing basic rights for protecting patents, designs, and trademarks.

A person who files for a patent or trademark in one member country is given a right of priority for a fixed period of time to file in other countries. The right of priority gives the holder 12 months for patents (six months for trademarks) to file from the date of the first application filed in a Paris Convention country. This right of priority relieves the burden of filing applications in many countries simultaneously. National treatment means that a member country cannot discriminate against foreigners in granting patent or trademark protection. Rights conferred may be greater or less than provided under U.S. law, but they must be the same as those that the country provides its own nationals.

Article 5 of the Convention sanctions member countries to issue **compulsory licenses** to third parties if the patent or trademark owner does not use the patent or trademark. A compulsory license grants patent or trademark rights to third parties without the consent of the patent or trademark owner. Compulsory licenses cannot be issued any sooner than four years from the date of the grant of the patent. A compulsory license is not to be issued if the patentee gives legitimate reasons for its failure to work the patent or trademark. In addition, the parties granted licenses must pay reasonable royalty fees to the patent or trademark owner. U.S. patent law does not authorize the granting of such licenses.

Many countries require that an invention be worked locally to retain the benefit of the patent. Working a patent may require manufacture of the patented goods within the country, or it may be met by importation of goods covered by the patent, depending on the law of a particular country. The Paris Convention permits penalties for abuses of patent rights, such as noted above, granting compulsory license followed by possible forfeiture of the patent when the grant of a compulsory license is not sufficient to prevent abuses.

Compulsory Licenses: Government grants of statutory rights (patents) owned by one party for the use of other parties. Such licenses are found in some countries where an owner of intellectual property rights is required to use the rights or suffer a loss of exclusivity.

The **Patent Cooperation Treaty (PCT)** addresses procedural requirements that aim at simplifying the filing of, searching for, and publication of international patent applications. The PCT entered into force in 1978 and is open to any member of the Paris Convention. The PCT allows companies to file a uniform international application for protection in other member states. Individual national applications, however, must follow within 18 months.

Berne Convention and Universal Copyright Convention

There is no such thing as an international copyright that automatically protects an author's work throughout the world. Protection against unauthorized use depends on the enforcement of national laws on a country-by-country basis. Most country laws, however, do recognize foreign works under certain conditions. This recognition of foreign works has been simplified through the enactment of international copyright treaties. Copyright protection has been seen as a moral right of authors and artists in their works. The moral nature of copyrights is inscribed in the cupola above the lobby at WIPO headquarters. It states that: "human genius is the source of all works of art and invention. These works are the guarantee of a life worthy of men. It is the duty of the state to protect the arts and inventions with care." See Figure 18.5 *Comparative Law*: "Ten Rights of Authors and Artists (Berne Convention)."

The level and scope of copyright protection available within a country depends on that country's domestic laws and treaty obligations. In most countries, the place of first publication is an important criterion for determining whether foreign works are eligible for copyright protection. Works first published in the U.S. are protected in more than 80 countries under the **Berne Convention for the Protection of Literary and Artistic Works**. The U.S. also maintains copyright agreements with a number of countries under a second international agreement called the

Moral Right: The right to preserve the integrity of the work including the right to publish the work. This is an inalienable right that cannot be assigned to an employer or another.

Reproduction Right: The right over all sound and visual recordings and adaptations of the work.

Translation Right: Right over the authorization of translations into other languages except for the limited right of less developed countries to grant compulsory licenses for translations.

Public Performance Right: Right over the performance of dramatic, musical, and literary works.

Broadcasting Right: Right over performances including radio and television broadcasts.

Adaptation Right: Indicates that a broadcaster needs to obtain permission of both the original author and the adapter or arranger.

Recording Right: This right covers recording of musical or dramatic works.

Author's Film Right: The right of the original author to authorize a film of the work.

Rights of Film Creator: Recognizes the separate rights of the owner or creator of the cinematographic work (film).

Right of Pursuit: Allows national laws to create a right of pursuit to an interest in the secondary and subsequent sales of the work. Thus, if the author or his heirs sell or transfer the rights to the work, they may still claim an interest in the subsequent sale or transfer by the transferee.

Figure 18.5 *Comparative Law: Ten Rights of Authors and Artists.*

(Berne Convention).

Universal Copyright Convention. Universal Copyright Convention countries that do not also adhere to the Berne Convention often require compliance with certain formalities to maintain copyright protection. These formalities require that the copyright be registered and that published copies of a work bear copyright notice, the name of the author, and the date of first publication. The U.S. also has bilateral copyright agreements with a number of countries; the laws of these countries may or may not be consistent with either of the copyright conventions. Before first publication of a work anywhere, it is advisable to investigate the scope of and requirements for maintaining copyright protection for those countries in which copyright protection is desired.

The Berne Convention, originally enacted in 1886, has been amended numerous times. A review of the Convention and its amendments illustrates the types of rights protected under the notion of copyright. Although created to protect the author and artists of artistic and literary works directly, the secondary purpose of the Berne Convention has been “to safeguard the large sums of money invested in producing informational goods and services” that are subsequently produced by publishers and others.

The Berne Convention firmly established the rights of authors as a principle of international law, but left it primarily to national laws to determine the degree of protection required. For example, it is left to national law to determine what types of works shall be given protection. Once a type of work is afforded protection, then a country is required to extend to foreign authors the same protections granted to national authors. A major limitation on this nondiscrimination principle is that if a country’s domestic law grants a longer term of protection than the laws of the author’s country of origin, then that country need only grant a term of protection equivalent to the law of the author’s country of origin and not the longer term that is given under its own laws.

Subsequent amendments to the Convention expanded the scope of its reach, created additional rights, and recognized new technological developments. These amendments included the Berlin Act of 1908, the Rome Act of 1928, the Brussels Act of 1948, the Stockholm Act of 1967, and the Paris Act of 1971. The **Berlin Act of 1908** recognized for the first time that photographic works were to be given copyright protection. These rights included the right to authorize the adaptation of an original work and the right over subsequent public performances of recordings of the work. This was a response to the emerging technologies of sound recording, cinematography, and photography.

The **Rome Act of 1928** recognized the moral rights of authors and the author’s broadcast rights in his works. The moral right allows an author to object to any distortion or other modification of the work. The moral rights of authors are now recognized in Article 6*bis* of the Berne Convention, which states that: “independently of the author’s economic rights, and even after the transfer of those rights, the author shall have the right to object to any distortion, mutilation, or other modification of the work, which would be prejudicial to his honor or reputation.” Thus, an author could sell the right to reproduce or publicly display his work, but retain the ability to reject any modification of it in the reproduction or display. The Rome Act through Article 11*bis* established a broadcast right in response to the development of public radio. It states that: “the authors of literary and artistic works enjoy the exclusive right to

authorize communication of their works to the public by radio.” Thus, for the first time a right was premised not upon a specific act such as reproduction or performing, but on a “process” of communicating the work.

The **Brussels Act of 1948** extended copyright protection to movie films. However, it was left to national law to determine the author or owner of the copyrights to a film. English law places that right with the producer of a film. In contrast, the civil law countries of Europe grant the rights to creative individuals such as the author of the original story or the writer of the screenplay. The Brussels Act also extended the broadcast right recognized in the Rome Act from sound broadcasting (radio) to television. The **Stockholm Act of 1967** and **Paris Act of 1971** allowed less developed countries to impose compulsory licenses for works out of print or for the translation of works not available in the language of the country.

A relatively new area for the expansion of copyright has been to protect traditional or **indigenous rights**. Indigenous peoples possess unique information and resources, which in some cases have become public or have been used, without the permission of the originators or any economic return or recognition. Indigenous rights refer to “traditional knowledge” (agriculture and medicinal plants) and “traditional cultural expressions” (handicrafts, dances, songs and stories), and that these creations should be under the control of the communities who generate them.

Agreement on Trade-Related Aspects of Intellectual Property Rights

TRIPS is divided into three parts, which provide: general provisions, scope of intellectual property rights, and enforcement provisions. “General Provisions and Basic Principles” (Part I) defines the principles of national treatment, most-favored-nation treatment, and transparency. “Standards Concerning the Availability, Scope, and Use of Intellectual Property Rights” (Part II) provides the minimum protections for: (1) copyright and related rights; (2) trademarks; (3) geographical indications (country of origin); (4) industrial designs; and (5) patents. Part III provides the type of enforcement mechanisms for violations of intellectual property rights. The following review will not only furnish an understanding of TRIPS, but will also reinforce the reader’s knowledge of the basic principles of intellectual property protection.

General Principles

The “General Provisions” of TRIPS restate the foundational tenets of the GATT-WTO system, including the national treatment, most-favored-nation, and transparency principles. See Chapter 6’s discussion of the core principles of the WTO agreements. Transparency is mandated in Article 63 of TRIPS. It states that “laws and regulations, and final judicial decisions and administrative rulings of general application, made effective by any Member pertaining to the availability, scope, acquisition, enforcement, and prevention of the abuse of intellectual property rights shall be published.” Under the transparency standards of Article 63, countries are required to transmit copies of their laws and regulations to the **Council for Trade-Related Aspects of Intellectual Property**. The Council, along with the WIPO, should be used as a resource for those interested in intellectual property protection. Article 69, for example, implicitly recognizes the problem of “illegal” gray market imports. It requires each country to establish “contact points” in their governments in order to coordinate with other countries in preventing the importation of goods produced in violation of rights recognized under TRIPS.

Copyright and Related Rights

TRIPS require all WTO members to immediately accede to the Berne Convention. As in the Berne Convention, copyright protection is extended to computer programs, whether in source or object code, as literary works. Copyright protection is also expressly extended to “compilations of data or other material, whether in machine-readable or other form which by reason of the selection or arrangement of their contents constitute intellectual creations.” Thus, databases or customer lists are protected under copyright. The minimum **term of protection** for photographic work or a work of applied art is no less than 50 years from its authorized publication or, failing such authorized publication, within 50 years from the making of the work.

Trademark Protection

Section 2 of TRIPS outlines the parameters for trademark protection. Article 15 of that section provides a broad definition, including that such signs made up of particular words including personal names, letters, numerals, figurative elements, and combinations of colors, as well as any combination of such signs, are eligible for registration as trademarks. Once recognized as a trademark, the owner of the trademark has the right to prohibit infringement of the trademark. Article 17 recognizes the fair use concept found in copyright law and applies it as an exception to trademark protection. The period of protection for trademarks and renewals is set at a minimum of seven years. However, TRIPS states that: “the registration of a trademark shall be renewable indefinitely.”

TRIPS recognizes the principle that trademark rights can be lost through abandonment or nonuse, but rejects the notion of compulsory licensing found in some national laws. Article 19 allows a country to cancel a trademark registration if it is unused for a period of three years. It prohibits such cancellation if the reason for nonuse was due to events outside the control of the registrant, such as import restrictions or government regulation. Article 9 recognizes Article 6bis of the Paris Convention, giving the owner of a *well-known* trademark the right to block or cancel an unauthorized registration of its marks in a foreign country.

Patent Protection

Article 27 of TRIPS defines *patentable* as something that is “new, involves an inventive step and is capable of industrial application.” The rights conferred on the patent owner include the right to prevent third parties from the acts of making, using, offering for sale, selling, or *importing* for these purposes the patented product or process. Interestingly, instead of recognizing integrated circuit designs as patentable, TRIPS recognizes such designs separately and provides for a ten-year period of protection from the date of application or from the date of the “first commercial exploitation.” It requires members to agree to provide protection for the layout and design of integrated circuits pursuant to the **Treaty on Intellectual Property in Respect of Integrated Circuits**.

Trade Secrets

Trade secrets are recognized under Section 7 of TRIPS. It states that the purpose of recognizing trade secrets is the “protection of undisclosed information.” Trade secret is defined as information having commercial value that is not commonly known and for which reasonable steps have been taken to maintain secrecy. An example of a reasonable step is requiring employees and agents to sign confidentiality agreements. Article 40 is of special importance to licensors of intellectual property rights. Countries are allowed to prohibit certain contractual restrictions that have “adverse effects on trade and *may* impede the transfer of technology.” Article 40 allows member states to single out for scrutiny contractual restrictions found in exclusive grant-back clauses and clauses that prohibit challenges to the validity of the licensor’s rights. These contract clauses will be discussed in Chapter 19.

Remedies and Penalties

TRIPS provide a menu of penalties and remedies to parties seeking the enforcement and protection of their intellectual property rights. Countries are required to provide civil and criminal remedies, along with procedures for seizing and destroying illegal goods. Civil remedies include damages for lost profits and attorney’s fees, along with the granting of injunctions to prevent imported goods from entering “the channels of commerce.” Special provisions are included in TRIPS to prevent through the customs authorities the entry of infringing goods. The owner of intellectual property rights may petition the government or customs authority to suspend the importation or exportation of infringing goods. Before granting the suspension, the administrative or judicial authority may require that the petitioner supply security, which can be used to indemnify a party whose goods are wrongfully enjoined or suspended.

Foreign Intellectual Property Laws

Centers of technological and other innovation in different areas are now developing in different parts of the world, including Hong Kong, Singapore, Malaysia, China, United Arab Emirates, and Costa Rica. The patent offices of China, New Zealand, Mexico, the U.S., and the Russian Federation reported the largest growth in patent filings. The main contributor countries for this growth were China, the U.S., and Korea, with the Chinese patent office rising to become the largest patent office in the world in 2011 in terms of patent applications filed. In 2012, residents of China accounted for the largest numbers of applications filed throughout the world for patents, utility models, trademarks, and industrial designs, and the relevant Chinese patent and trademark offices were also the largest recipients of filings for these four types of intellectual property. Therefore, it is important to research the different national laws relating to intellectual property.

Regional Patent Treaties

Regional patent treaties have served to advance stronger intellectual property protections. There are two types of regional organizations. The first type establishes a regional patent system. The second attempts to harmonize existing patent systems within a region. An example of the second type is the Common Regime on Industrial Property adopted by the Andean Community in 2000. As to the first type, there are currently five regional treaties that have offices that issue regional patents: (1) African Intellectual Property Organization (OAPI), (2) African Regional Intellectual Property Organization (ARIPO), (3) **Eurasian Patent Office (EAPO)**, (4) **European Patent Office (EPO)**, and (5) Gulf Cooperation Council Patent Office (GCC). In addition, along with the EU, the North American Free Trade Agreement (NAFTA), as well as with other free trade agreements, incorporate intellectual property protections. The EU and NAFTA intellectual property protections will be discussed later in this chapter.

The OAPI consists of 16 French-speaking countries of Africa. None of the 16 countries has a national patent system and, therefore, OAPI patents are automatically effective in the countries that make up the OAPI. ARIPO was established by the Harare Protocol of 1982, creating a regional patent office for 17 English-speaking countries in Africa. After the issuance of an ARIPO patent, the member countries have six months to deny the patent's applicability in their countries. Also, the patent is subject to the compulsory licensing laws of the individual countries. The EAPO issues a regional patent for Russia and eight other countries (Azerbaijan, Belarus, Kazakhstan, Tajikistan, Turkmenistan, Kyrgyzstan, Moldova, and Armenia) that were previously part of the Soviet Union. Upon issuance, the patent owner selects the countries for which the patent will be effective.

The *European Patent Convention* (EPC) of 1977 established the EPO. All 28 members of the EU, as well as an additional ten other European countries, are parties to the EPC. An EPC patent is equivalent to a national patent in each of the member countries and is enforced in the same manner as national patents in the courts of the individual countries. Some countries require that for the patent to take effect, the patent owner must have it translated into the national language. In order to acquire the **Single European Patent**, an application needs to be submitted to the EPO in Munich. In the area of trademarks, the EU Trademark Office in Alicante, Spain, issues a single **EU Trademark** that is valid in 15 EU countries. It should be noted that national trademarks continue to coexist with the EU trademark. In 2013, 25 EU countries agreed to create the Uniform Patent Court, which is able to hear patent infringement cases, as an alternative to filing a claim in a national court system.

Foreign Trademark Law

In most countries of the world a trademark is recognized and protected only on the registration of the mark with the appropriate government agency. Article 2 of the **Russian Trademark Law** states that "legal protection of a trademark within the Russian Federation shall be granted upon its registration with the State." The system that allocates rights based upon the **first to register principle** is referred to as an **attributive system**. That is, all rights stem from the registration of the trademark or patent. Most countries, however, as required by international trademark conventions, authorize their trademark offices to reject the registration by third parties of internationally

recognized or famous trademarks. Article 7 of the Russian law states that “trademarks of other persons are protected *without* registration by virtue of international treaties to which the Russian Federation is a signatory.”

Brazil first recognized the rights of unregistered foreign trademark owners in revising its industrial property law in 1997. The new **Brazilian Industrial Property Law** allows the trademark office to “reject an application for registration of marks that wholly or partially reproduce or imitate a well-known mark.” In determining whether a trademark is a well-known mark, the law refers to the Paris Convention. Article 126 of the law states that “trademarks that are well known in the terms of Article 6*bis* of the Paris Convention will enjoy special protection, irrespective of their previous filing or registration in Brazil.” However, the window of opportunity to obtain the rights to a trademark is narrow. A contesting party, usually the rightful owner or a licensee, has only 60 days from the time it contests a trademark registration to apply for its own trademark.

The Brazilian law also allows the trademark owner to sue for damages. Article 210 provides that the infringer may be sued for lost profits. The lost profit calculation is the one most favorable to the injured party. Thus, the foreign trademark owner can receive the higher of “the benefits it would have received but for the infringement or the value of the benefits received by the violator.” Under the old Brazilian law, a foreign holder of a trademark not only has to register the trademark, but also has to actively use it within two years of the registration. However, Brazil recently changed its law to conform to the Paris Convention and the Stockholm Revision that give protection as long as the trademark is registered in Brazil.

National trademark laws need to be researched for substantive differences. For example, a trademark owner should not only research the requirements or registering a trademark in a foreign country, but also for preserving the trademark under that national law. Three of the more common areas for concern include: (1) term of the trademark and the requirements for renewal; (2) preventing infringement of the trademark and having it be used generically and not as a brand name; (3) preventing it from being labeled as an abandoned trademark due to nonuse.

Under Russian Law, a registration of a trademark is valid for a period of ten years calculated from the date of receipt of the application. The trademark may be renewed every ten years by filing a renewal request within the last year of the previous registration period. In the event that a registration or a renewal request is rejected, the applicant has three months to appeal the decision to the Chamber of the Patent Authority. An applicant may appeal the decision of the Patent Authority, within six months, to the Supreme Patent Authority.

Trademark laws are relatively uniform regarding treatment of a trademark. The general rule is that a trademark that is used generically loses its trademark protection. Alternatively stated, if a trademark or trade name is used to refer to all goods of a certain type and not just to a particular brand name, then all trademark rights are expunged. The *Comité Interprofessionnel du Vin de Champagne* case explores the generic-brand name distinction. Note that in an international setting a trademark may be considered generic in one country and a protected brand name in another.

Comité Interprofessionnel du Vin de Champagne v. Wineworths

2 NZLR 432 (1991)

The Comité Interprofessionnel du Vin de Champagne (CIVC) is a semiofficial body created under French law whose purpose is the protection of the name Champagne. It is disputing with Australian wine interests active in the New Zealand market for sparkling wine that Australian exporters seek to label and sell as champagne. The main dispute is over whether, in New Zealand, the word “Champagne” had crossed the divide from a distinctive (brand) name to a generic word. Champagne as we know it is relatively new, having its final development in the 19th century by Dom Perignon of the Benedictine Abbey

near Epernay, France. The two features of Champagne of prime importance are the soil and climate in which the grapes are grown, and the method of manufacture by skilled personnel.

The essence of the *methode champenoise* is that the process of second fermentation takes place in the bottle in which it is sold. That requires an operation for shifting the yeast by gradual manipulation down the neck of the inverted bottle for its removal. This was in contrast to Australia where indigenous wine manufacture and drinking became a more integral part of the lifestyle.

The plaintiffs recognize that for Australia, like Canada and the United States, there is no legal protection available to them over the use of the appellation *champagne*.

In 1987, Penfolds (Australia) reached an agreement with Wineworths (New Zealand) to export into New Zealand a sparkling wine bearing the label “Australian Champagne.” Plaintiffs brought suit claiming that the defendants were guilty of the charge of passing off. It is appropriate to emphasize the plaintiffs’ view of what makes the product and name so special. It is avowedly alcoholic and readily capable of producing a pleasurable effect in the stomach. Champagne is appropriate as a wine with which to celebrate; characteristics are that it palpably agitates in the glass, that it is reinforced by exotic origin (France), and its cost.

Is Champagne a Generic Term?

The Court’s central task is to determine the overall perception of New Zealanders of the word *champagne*. The following categories of evidence are singled out: (1) dictionaries and linguistic experts, (2) market research, (3) wine expert witnesses, and (4) restaurant wine lists and newspaper advertisements. Based on this evidence, the Court’s decision is that the word champagne in New Zealand is not generically used to describe any white sparkling wine.

Law of Passing Off

The cause of action is not of the classic form whereby one manufacturer seeks to disguise its goods as those of another by imitating name or style of packaging so as to pass off or deceive a buyer as to the true nature of the purchase. This complaint is of a new type of passing off, which is characterized by inconspicuous attachment, and invalid sharing, of a reputation. This new level of passing off makes the identification of the misrepresentation or deceit an indispensable ingredient for liability, which is more difficult to prove. The plaintiffs concede that there is no attempt to sell the wine as French wine. They do suggest buyers would think they were buying sparkling wine with all the attractive attributes of Champagne because the product is described by the word.

The essentials of a claim of passing off can be stated within three elements: (1) The case must establish sufficient

reputation or goodwill in the name Champagne, (2) The heart of the case is the obligation to show that the challenged actions are likely to cause, or have actually caused, deception, and (3) The plaintiffs suffered or are likely to suffer damage or injury to their business or goodwill. First, there has already been a finding that the word *champagne* retains a distinctive reputation and goodwill and has not become a generic word. Second, the Court’s decision is that it is deceptive. Third, the plaintiffs will suffer damage if the word champagne is used on any sparkling wine sold in New Zealand. It follows that the public of New Zealand, by which the Court means the ordinary purchaser without special knowledge of wines and who does not specifically concentrate on differentiation, or is even troubled and carefree about such matters, is likely to be misled. Judgement for Plaintiffs.

Case Highlights

- “Passing off” is a form of trademark infringement characterized by inconspicuous attachment and invalid sharing of a reputation.
- The crucial factor in passing off is the distinctiveness of the trademark and whether it has become generically used.
- The standard for making the brand name-generic distinction is the perspective of the “ordinary purchaser” or consumer.
- For purposes of conversation at future cocktail parties, note the distinction between champagne that is fermented in “the” bottle versus in “this” bottle. The *methode champenoise* requires that the champagne remain in the bottle while impurities are removed during the second fermentation process. Experts turning the bottle over a prolonged period of time “magically” remove the impurities. This is an expensive process and is referred to as in “this” bottle. The cheaper method involves pumping the champagne out of the bottle, removing the impurities by a machine process, and then returning the future champagne by pumping it into another bottle for the second fermentation. This second method is referred to as in “the” bottle. If used adeptly this bit of trivia can help earn you a cosmopolitan reputation.

A large number of countries require the owner of a trademark to use the mark or lose protection under their trademark law. Russian Trademark Law allows the Supreme Patent Chamber to terminate a trademark registration when “any person demonstrates the nonuse of the trademark for a period of five years.” The law provides that the registration will not be invalidated in the event that the owner of the trademark shows that its failure to utilize the

trademark was for reasons beyond its control. If, for example, the sale of trademarked goods was prevented due to import or export controls, then the owner will retain its trademark rights. Chinese trademark law provides for the canceling of a registered trademark in the event that it has not been used for three consecutive years.

The People's Republic of China views the purpose of intellectual property law in a unique way. Besides the traditional purposes of protecting private property and to encourage technological development, the Chinese see trademark law as a mechanism for quality control and consumer protection. Article 31 of the Chinese Trademark Law authorizes the Trademark Office to revoke a registered trademark if a trademarked good is not of reasonable quality. The law is aimed at providing protection only for trademarks for goods of at least average quality. Thus, a trademark owner that produces goods of inferior quality is seen as deceiving consumers. This deception is based on the assumption that if a good is trademarked, then it is of reasonable quality.

Foreign Patent Law

In the area of what types of inventions are protected under patent law, there is a great deal of uniformity among the national legal systems. Chinese patent law mimics U.S. law in defining a “patentable” invention as one that possesses *novelty*, *creativity*, and *utility*. Article 22 of the **Patent Law of the People's Republic of China** describes novelty as an invention that has previously not been published or publicly used. Creativity is defined as a substantial progress over existing technology. Utility requires that the invention be capable of being manufactured or producing a “positive effect.” In the *Honda Motor Co. v. Beijing Xuyang Hengxing Trade Co.* case that follows, a Higher People's Court (see Chapter 9) explores the concepts of primary and secondary liability, as well as the remedy of disgorgement of profits earned by the infringing parties.

Honda Motor Co., Ltd v. Beijing Xuyang Hengxing Trade Co., Ltd

Beijing Higher People's Court (2010) GMZZD No. 2556

Issue: Where a party entrusts another to produce components and assemble the components into a completed product, if the components are patent infringing who assumes liability for paying compensation for the infringement?

Primary and Secondary Liability

Article 11(2) of the Patent Law of China provides that, after the granting of a design patent no entity or individual is entitled to without permission of the patentee (owner) exploit the patent; that is, make, sell or import the product incorporating its patented design, for production or business purposes. Honda is the owner of the patent at issue, and its rights are protected under the Patent Law of China. In this case, the infringing products accused and the patent products at issue are car bumpers. Through comparison, the alleged infringing products and the patent products at issue are similar in design.

There are many accessories and parts designed by a car manufacturer together with the cars' overall appearance. Therefore, although some of the parts and accessories are manufactured by others, namely, Jiangsu Kawei Motor Accessories Co., Ltd. (Kawei) in this case, but the

drawings are provided by the car manufacturers, namely Shijiazhuang Shuanghuan Motor Inc. (Shuanghuan). Shuanghuan has sold the cars with the infringing bumpers.

Therefore, both Shuanghuan and Kawei have infringed the patentee, Honda's patent rights. They shall stop such infringement and undertake joint and several liabilities to Honda for its losses. Since Shuanghuan is the designer and manufacturer of the car, he shall undertake the primary liability. Kawei is the hiree of the infringing designer, and his degree of fault is less than Shuanghuan. Therefore, Kawei shall undertake secondary liability. Furthermore, Beijing Xuyang Hengxing Trade Co., Ltd. (Xuyang) has sold the cars with infringing products, and he shall stop selling such cars.

Calculation of Damages

Article 21 (1) and (3) of the *Provisions of the Supreme People's Court on Issues Concerning the Trial of Patent Controversies* provide that, when ascertaining the infringer's liabilities in accordance with Patent Law of China, the court may fix the amount of compensation in light of the losses suffered by patentee or the benefits

obtained by the infringer from the infringement. Benefits obtained by the infringer may be ascertained in light of the total amount of sales multiplying the reasonable profits of each infringing product. Generally, the interests obtained by the infringer shall be calculated in light of his operating profits.

According to the Audit Report and Consultation Report presented by Shuanghuan in another case, we may ascertain the costs and profits of car sales and amounts of sales; according to the presented invoices issued to Shuanghuan, the back bumper's unit price is RMB 286.32 Yuan. Therefore, we may ascertain the proportion of the back bumper to the whole car. Accordingly, this court ascertains that the interests obtained by Shuanghuan and Kawei's infringement are RMB 1.72 Million Yuan. And Shuanghuan and Kawei

shall undertake joint and several liabilities for such damages.

Case Highlights

- The owner–patentee of a design patent may prevent any entity or individual, without permission of the patentee, to exploit the patent; that is, make, sell, or import any product incorporating its patented design.
- More than one party may be sued for infringement of patents in a given case, with each party deemed to be jointly and severally liable (each liable for the entire damages). However, the infringement damages may be allocated between the primary infringer (car designer) and a secondary infringer (part manufacturer).
- In calculating liability, damages may be based on the profits obtained by the infringing parties in violating the patentee's patent rights.

Chinese patent law adopts the notion of compulsory licensing found in a large number of developing countries, not often used under U.S. law. Chinese patent law requires the patent holder to *work* the patent in China. To satisfy the work requirement, a foreign patent holder will need to produce the good in China, enter into a joint venture to produce the good in China, or license someone in China to produce the good. In the event that he fails to work the license for a period of three years, the State Patent Bureau is authorized to grant compulsory patent licenses to third parties. Holders of the compulsory licenses are then legally able to produce the patented product. They must, however, pay a reasonable royalty to the original patent holder. Compulsory licenses are also granted to parties who have improved on a previous invention or whose new invention relies upon a previous patent. Often the government will grant a **reciprocal license** to the prior patent holder to be able to use the new invention.

European Union

In the area of trademarks, a person or company may obtain a single EU Trademark; however, national trademarks continue to coexist with the EU trademark. Figure 18.6 *Comparative Law*: “EU Regulation on the Community Trademark” provides excerpts from Regulation 2868/95 implementing the EU Trademark Directive. This regulation is binding in its entirety and directly applicable in all EU countries. Among other things, it calls for uniform forms for applying, contesting, and renewing trademarks, along with the option of converting a community trademark application into a national application. The regulations also provide for the registering of licenses by licensees.

EU Database Protection

Only the EU has adopted a legal regime for the protection of databases through the adoption in 1996 of the Database Directive, which grants the maker of a database a *sui generis* right to control the uses of the contents. The Directive confirms the availability of copyright-like protections for authors of the databases. According to the Directive, legal protection is attached to each element incorporated into the database if its creation is sufficiently original to be qualified as the “author’s own intellectual creation.” The *sui generis* right is accorded if the database maker can demonstrate that he has made a qualitatively or quantitatively *substantial investment* either in the attention, verification, or presentation of the contents of the database.

The concept of substantial investment has come under close scrutiny in the European Court of Justice (ECJ). ECJ decisions in four famous cases (involving British Horses Board and Fixtures Marketing), gave a restrictive interpretation, thus curtailing the availability and scope of the database *sui generis* protections. Indeed, the ECJ

This Regulation contains the necessary provisions for a procedure leading to the registration of a Community trademark, as well as for the administration of Community trademarks.

Rule 22: Proof of Use

Where the party has to furnish proof of use or show that there are proper reasons for nonuse, the Office shall invite him to provide the proof required. If the opposing party does not provide such proof before the time limit expires, the Office shall reject the opposition.

Rule 23: Registration of the Trademark and Rule 85: Community Trade Marks Bulletin

The registration shall be published in the Community Trade Marks Bulletin. The Community Trade Marks Bulletin shall also contain publications of applications.

Rule 34: Special Provisions for the Registration of a License

A license in respect of a Community trademark shall be recorded in the Register as an exclusive license if the proprietor of the trademark or the licensee so request.

Rule 44: Application for Conversion

An application may be made for conversion of a Community trademark application or a registered Community trademark into a national trademark application.

Figure 18.6 Comparative Law: EU Regulation on the Community Trademark.

made a distinction between “creating” and “obtaining” the data. In its view, “creating” the data to be gathered in the database does not qualify as a relevant investment for the granting of database protection. Conversely, obtaining or collecting existing data may qualify as an investment under the Database Directive; yet the investment may not be substantial enough, especially if the collection is made with standard hardware, software, or Internet tools.

NAFTA Intellectual Property Rights Protection

On December 17, 1992, the leaders of the United States, Mexico, and Canada signed the NAFTA, which contains a comprehensive multilateral intellectual property agreement. Prior to NAFTA, U.S., Canadian, and Mexican standards for the protection and enforcement of intellectual property rights differed. NAFTA’s scope of intellectual property protection includes copyright, trademarks, trade secrets, and patents. In addition, NAFTA also protects semiconductors, geographical indications, satellite broadcast signals, industrial designs, and sound recordings.

The Agreement requires each country to treat nationals of the other countries in a manner that is no less favorable than that accorded its own nationals. In general, this “national treatment” principle means that intellectual property owned by a U.S. national and distributed in Mexico and Canada will receive, at a minimum, the same degree of intellectual property protection in those countries, as would native products.

NAFTA’s definition of computer programs as literary works increases the scope of copyright protection for the software industry in Mexico, where computer programs were previously not defined as literary works. Thus, software is accorded similar status as novels, plays, and other works of authorship. NAFTA also provides copyright protection for databases by providing protection similar to that afforded other copyrighted works. Another significant feature of NAFTA is that new subject matter discovered through technological innovation qualify as original expression and will automatically receive protection. This provision takes into account the pace of continuing technological change in multimedia industries and obviates the need to amend NAFTA in the future to accommodate new technologies.

The main focus of the patent negotiations centered on Canadian compulsory licensing practices. One of NAFTA’s major achievements was to severely limit these practices, which required American and other foreign industries to grant licenses to Canadian companies or individuals to use their patented products.

Trade secret law is designed to prevent the unauthorized use and disclosure of confidential information. One problem for high-tech companies and other industries in trying to conduct international business has been the lack of protection for confidential information. In addition, various countries place limitations on how long proprietary information can remain confidential.

Due to NAFTA, Mexico has instituted comprehensive national provisions for the protection of trade secrets.

One of the weakest links in the protection of intellectual property has been the lack of enforcement mechanisms. NAFTA commits to a far-reaching regime of intellectual property rights enforcement. It establishes detailed obligations for enforcement procedures and provides for cooperation and technical assistance among the member countries. NAFTA requires member countries to have enforcement procedures that are similar to those that already exist in the U.S., including general due process, injunctive measures against infringing goods, and payment of damages for harm suffered.

IPR Infringement in Transitional and Emerging Economies

Protection of intellectual property rights in many countries is hampered by inadequate enforcement of the relevant laws and regulations. The **U.S. Trade Representative (USTR)** maintains an intellectual property rights “**watch list**” under Section 301 of the U.S. Trade Act of 1988.²¹ This list should be examined prior to making the decision to license in another country.

Some IPR owners, in protecting their products from IPR infringement, choose to file claims in the foreign legal system, but cases may take years before they are finally resolved. Occasionally, foreign companies work with local law firms and law enforcement officials to conduct police raids on counterfeiters. Others conduct periodic seminars on the adverse effects of IPR infringement on the local economy, one of which is reduced investment by foreign companies.

Ultimately, the course taken by companies to protect their intellectual property rights will depend on their product. As an example, one strategy is to identify the counterfeiters and then proceed to work with them and sign them as legal licensees of the products. Some computer software companies provide free training and sell their software at competitive prices, while warning that copies of their product may contain damaging viruses. In general, acquiring a strong local partner or agent can help in defending trademarks and intellectual property.

The general patent principle is that the owner of a patent is the party who is “first to register” at a national patent office.²² Thus, an American patent holder may find it difficult to prevent infringement unless it takes the necessary steps to register its patent in foreign countries. The best approach is to secure the services of a **patent agent**²³ in order to obtain the necessary patents (and trademarks) within in foreign country. A second issue is the ownership and protection of inventions created by an employee. Employee inventions belong to the employer, but in some countries the employer must remunerate the employee for the invention and in other countries the employer must file a patent application within a certain period of time or risk losing ownership to the employee. In such countries, a written employment contract should provide for a formal notification procedure, establish the obligation of the employee to cooperate in the filing of a patent application, and detail the amount of remuneration that will be paid to the employee.

Another issue that is not recognized in the U.S. but is not uncommon in other countries is the notion of compulsory licensing to junior patent holders. If a licensee or a third party makes an improvement on a patent that has not been used for a designated period of time, then the patent holder must grant the improvement owner a license to use the underlying patent or technology. The junior patent holder must show that it cannot use its patent without infringing on the rights of the other senior patent holder. The danger of this law is that “a minor improvement by a second inventor theoretically gives him the right to a license without a reciprocal requirement to license the first.”²⁴ For this reason, it is important to periodically use or work patents in order to preclude the creation of second inventor rights.

A number of tangential issues should be explored by the licensor (IPR owner) before entering into a licensing agreement. First, all protections provided by international conventions should be explored. Second, in some countries it is important to pay periodic maintenance fees. Failure to pay such fees can result in a termination of the patent. Third, in some countries, a licensor is required to record any license, transfer, or assignment of property rights for the contract (license) to be enforceable. Fourth, the licensee should be required to enter into employment contracts with its employees, which clearly delineate ownership of rights to any improvements made to the licensed technology. Fifth, a strong “best efforts” clause should be incorporated into any transfer agreement to prevent claims of abandonment and to prevent the issuance of compulsory licenses. Sixth, any regional intellectual property

regime should be considered, such as the EU Community Mark or the Eurasian patent. In the latter case, the foreign licensor files an application in the EAPO in Moscow.

Developing an Intellectual Property Protection Strategy

Before entering a foreign market, an intellectual property owner or licensor should develop a strategy or checklist to protect its IP rights. Following is an example of such a strategy, using Russia as the target market: (1) explore all protections provided by international conventions. Russia is currently a party to the Patent Cooperation Treaty, Madrid Protocol, Berne Convention, and Universal Copyright Convention, along with the Paris Convention. These treaty commitments supersede domestic patent law; (2) use a patent agent to obtain a Russian patent, along with any necessary copyrights and trademarks; (3) determine duties or fees payable during the patent term. After obtaining a Russian patent it is important to pay periodic maintenance fees. Failure to pay such fees can result in a termination of the patents; (4) be sure to satisfy all notice and registration requirements. In Russia, a licensor is required to record any transfer or assignment of property rights. For example, patent transfers or licenses must be registered with the Patent Office; (5) define ownership rights for employees. In Russia, licensees should be required to enter into employment contracts with their employees that clearly delineate ownership of rights to any improvements made to the licensed technology; (6) explore enforcement options. Because of the poor track record of enforcement by the Russian civil court system, entering license agreements with infringing parties may need to be pursued; (7) protect against compulsory licenses, if necessary. In Russia, a strong best efforts clause should be incorporated into any transfer agreement to prevent claims of abandonment and the issuing of compulsory licenses. Chapter 19 will explain the nature of the best efforts clause; and (8) the Eurasian Patent Convention should be utilized when appropriate. This Convention allows a Russian patent to be expanded to include a number of other former Soviet republics. The foreign licensor may file an application in the EAPO in Moscow.

Finally, the licensor should enlist the services of **International Patent Searching Authorities (ISA)** when filing foreign patent applications. A number of national patent offices, including Russia, the U.S., and Japan, as well as the EPO, recognize patent search certificates produced by this private company, which confirms that there are no existing patents equivalent to the one on the patent application. ISA will forward the search report and the international patent application authorized under the Patent Cooperation Treaty to signatory countries.

Chapter Summary

- 1 The value of intellectual property rights and the licensing of those rights have become a substantial percentage of international trade. The core intellectual property protections relate to patents, trademarks, copyrights, and trade secrets. Databases and software have been increasingly recognized as deserving of legal protection.
- 2 Trademarks protect the brand names and symbols related to a company's products or services and include the trademark for goods, trade dress, service marks, certification marks, and designations of place of origin. Trademarks are effective for a fixed period of time, usually ten years, but can be perpetually renewed unless the trademark is not protected and becomes a generic term. In order to bring a claim for trademark infringement, the claimant must show a likelihood of confusion (by consumers) between the senior mark and the junior or infringing mark. A claim can also be brought when there is no likelihood of confusion if a trademark is harmed due to blurring or tarnishment.
- 3 Copyrights protect creative works, which extend from literary works, collective works such as movie and television productions, and live performances to computer programs. The major exceptions to copyright infringement include the first sale doctrine, fair use doctrine, public domain, and work for hire. Copyright protection is good for a period of 70 years after the death of the author or in cases of work for hire, 120 years.
- 4 Patents protect inventions, as well as processes and compositions of materials. In order to obtain a patent, the creation must be within one of the above patentable categories, as well as be useful, novel, and non-obvious. A patent's duration is 20 years. One of the major differences between American patent law and those of some other countries is the issuance of compulsory licenses for patents not being used by their owners. The U.S. does not grant or recognize compulsory licenses.

- 5 Trade secrets include confidential information that gives a company a competitive advantage over its competitors. It can include business know-how, secret ingredients or formulas, and customer lists or databases. Trade secrets are protected from theft or unauthorized usage as long as the owner keeps them secret.
- 6 The major international intellectual property conventions include the Berne Convention (copyright), Uniform Copyright Convention, Paris Convention (patents and trademarks), Patent Cooperation Treaty, as well as the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).
- 7 At the regional level, European Union law provides for a Community Trademark, Single European Patent, and a unique intellectual property law regime that protects databases. Other regional intellectual property protection regimes include the North American Free Trade Agreement (NAFTA) and the Eurasian Patent Convention.

Key Terms

Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)	Fair Use Doctrine Federal Trademark Dilution Act (FTDA)	Right of Priority Rome Act of 1928 Russian Trademark Law
Anti-Bootlegging Statute	First Sale Doctrine	Secondary meaning
Attributive System	First to Register Principle	Senior Mark
Berlin Act of 1908	Generic Marks	Service Mark
Berne Convention for the Protection of Literary and Artistic Works	Gray Market	Single European Patent
Blurring	Indigenous Rights	Sound Recording Act of 1971
Brazilian Industrial Property Law	Innocent Infringement	Stockholm Act of 1967
Brussels Act of 1948	International Patent Searching Authorities (ISA)	Tangible Form
Business Software Alliance (BSA)	Junior Mark	Tarnishment
Collective Works	Lanham Act	Term of Protection
Compulsory License	Meta-tags	Trade Dress
Copyright Act of 1976	National Treatment	Trade Secret
Copyright Law	Paris Act of 1971	Trademark Dilution
Council for Trade-Related Aspects of Intellectual Property	Paris Convention	Trademark Law
Doctrine of Equivalents	Patent Agent	Treaty on Intellectual Property in Respect of Integrated Circuits
Economic Espionage Act of 1996 (EEA)	Patent Cooperation Treaty (PCT)	U.S. Trade Representative (USTR)
EU Trademark	Patent Law	Uniform Trade Secrets Act
Eurasian Patent Office (EAPO)	Patent Law of the People's Republic of China	Universal Copyright Convention
European Patent Office (EPO)	Patentee	Watch List
	Public Domain	Work for Hire
	Reciprocal License	World Intellectual Property Organization (WIPO)
	Registration	

Chapter Problems

- 1 What can a U.S. licensor of intellectual property rights do to prevent a gray market problem?
 - 2 What are the basic differences between the U.S. patent system and the patent systems found in other countries?
 - 3 *Conflicts of law rules* play an important role in the application of national intellectual property laws.
- Courts determine which national law is to be applied in the case by applying conflicts of law rules. They are applied when the parties are from different countries or the activities at issue transpired in different countries. The court must decide whether the law of the country of the plaintiff or the defendant, or of some other country should be applied. In a recent

case, Itar-Tass Russian News Agency sued *Kurier*, a Russian-language newspaper in New York that copied articles originally published by Itar-Tass, for copyright violation. Itar-Tass claimed *Kurier*'s publications of its articles violated the Berne Convention and Universal Copyright Convention. Under what law is the ownership of the articles to be determined? Does the Russian copyright owner have standing to sue for infringement in U.S. courts? *Itar-Tass Russian News Agency v. Russian Kurier, Inc.*, 153 F.3d 82 (2d Cir. 1998).

- 4 Justice Yates stated more than 200 years ago that: "Ideas are free. But while the author confines them to his study, they are like birds in a cage, which none but he can have a right to let fly: for, till he thinks proper to emancipate them, they are under his dominion." *Millar v. Taylor*, 4 Burr. 2303 (1769).

In 1859, Abraham Lincoln commented further that: "the patent system added the fuel of interest to the fire of genius." Using these statements explain the purpose of intellectual property laws. Also, how do these laws balance the need to protect the property of "creators" through the granting of "monopolies" over their rights and the goal of free competition?

- 5 L'Oreal applied for a patent on a sun protection factor (SPF) product in Luxembourg on April 13, 1987. It applied in the U.S. on April 12, 1988. Estee Lauder applied for a patent in the U.S. on the same SPF on December 21, 1987. Assuming that the Paris Convention and Patent Cooperation Treaty applied, who is entitled to the U.S. patent? *Estee Lauder Inc. v. L'Oreal, S.A.*, 129 F.3d 588 (Fed. Cir. 1997).

Internet Exercises

- 1 Search the U.S. Copyright Office web site and report the requirements for filing a copyright registration: www.loc.gov/copyright.
- 2 Research the activities of the World Intellectual Property Organization by reviewing its web site at www.wipo.org.
- 3 Review the 2015 Special 301 Report of the U.S. Trade Representative at www.ustr.gov. What countries are on the Representative's watch lists? Why are these countries on the lists? Be sure to scroll down to the sections titled "Priority Watch List" and "Watch List."
- 4 Review and compare the texts of the Uniform Trade Secrets Act (www.uniformlaws.org/shared/docs/trade%20secrets/utsa_final_85.pdf) and the Economic Espionage Act of 1996 (www.tscm.com). Scroll down to "U.S. Laws Regarding Electronic Surveillance." What types of activities do they prohibit? What types of information are protected? Are there any defenses to claims under these acts? What remedies or penalties are provided for violations?
- 5 On May 5, 2000, a Dispute Settlement Panel of the World Trade Organization issued its report

in the U.S.–Canada dispute over Canada's term of patent protection. The Panel essentially agreed with the U.S. that Canada's 17-year patent protection fails to comply with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights. Article 33 of TRIPS requires WTO members to provide a patent protection term of at least 20 years from filing for all patents existing on January 1, 1996. Canada relied on Article 28 of the Vienna Convention, arguing that there is a presumption against retroactivity for treaties. Review the Panel Report available on the WTO web site at www.wto.org.

- 6 Review the web sites of the U.S. Patent and Trademark Office (www.uspto.gov), European Patent Office (www.epo.org), and Japanese Patent Office (www.jpo.go.jp). Also through these web sites, research the work of the Trilateral Office. The U.S. PTO, EPO, and JPO established the Trilateral Office to facilitate cooperation in the administration of their patent functions (www.trilateral.net/index.html).

Other Internet Sources

U.S. Copyright Office: www.copyright.gov.

U.S. Patent and Trademark Office: www.uspto.gov.

U.S. Laws Regarding **Electronic Surveillance**: www.tscm.com.

World Intellectual Property Organization (WIPO): www.wipo.org.

Eurasian Patent Office: www.eapo.org.

International Patent Searching Authorities: www.wipo.int/pct/en/access/isa_ipca_agreements.html;
www.uspto.gov/web/offices/pac/mpep/s1840.html.

Notes

- 1 See *First Savings Bank v. First Bank System, Inc.*, 101 F.3d 645 (10th Cir. 1996).
- 2 15 USC § 1127 (1996).
- 3 15 USC § 1125.
- 4 17 USC § 109(a).
- 5 490 U.S. 730 (1989).
- 6 See www.bsa.org.
- 7 210 F.3d 439 (5th Cir. 2000).
- 8 117 S. Ct. 1040 (1997).
- 9 18 USC § 90.
- 10 1998 WL 538221 3d Cir. 1998.
- 11 971 P.2d 936 (Sup. Ct., Wash., 1999).
- 12 15 USCA §§ 1125(a) and 1127.
- 13 19 CFR Section 133.23a.
- 14 489 F.2d 809 (7th Cir. 1972).
- 15 344 U.S. 280 (1952).
- 16 19 USC Section 1526(e).
- 17 15 USC § 1114(1).
- 18 810 F.2d 1506 (9th Cir. 1987).
- 19 118 S. Ct. 1125 (1998).
- 20 18 USC § 2319A. See *U.S. v. Ali Moghadam*, 175 F.3d 1269 (11th Cir. 1999).
- 21 For the 2015 USTR Report, see www.stopfakes.gov/news/ustr-releases-2015-special-301-report.
- 22 It should be noted that Russia is a signatory of the Paris Convention. Therefore, the true inventor should have 12 months from the filing date in another country to file for a patent in Russia.
- 23 Russian patent agents are certified under the Statute of Patent Agents enacted in 1993.
- 24 Marina Portnova, "Ownership and Enforcement of Patent Rights in Russia: Protecting an Invention in the Existing Environment," 8 *Indiana International and Comparative Law Review* 505, 516 (1998).

INTELLECTUAL PROPERTY LICENSING

Chapter 18 reviewed foreign and international intellectual property law and some of their shortcomings. These shortcomings mean that the licensor-patentee of technology and intellectual property rights (IPR) must negotiate added protections in international licensing agreements. This chapter will analyze the contractual arrangements used in the field of intellectual property transfer, including a review of common clauses used to protect the rights of the licensor (owner of the IPR) and how best to protect the confidentiality of the licensor's property rights.

U.S. companies frequently license their IPR to foreign companies who manufacture and sell products abroad.¹ Licensing, from the licensor perspective, provides an inviting means of generating revenues without committing large amounts of capital. A technology or IPR licensing agreement enables a company to enter a foreign market quickly, and it poses fewer financial and legal risks than foreign direct investment. The **licensor** or owner of the technology and IPR can avoid the costs and time of exporting and importing goods across national borders, as well as avoid tariff and nontariff barriers. The licensing company also avoids the panoply of host country laws, such as tax, labor, and environmental laws that would need to be addressed when directly investing and developing a foreign market. Therefore, licensing can be attractive for small companies or companies with little international trade experience.

Technology transfer covers different types of agreements, such as highly complex agreements to conduct research and development abroad, to provide technical assistance to a subsidiary or joint venture, or to perform other activities under direct commercial licensing agreements between a manufacturer or IPR owner and a foreign entity. Technology licensing is a contractual arrangement in which the licensor's patents, trademarks, service marks, copyrights, or know-how are sold or otherwise made available to a **licensee** for compensation. Such compensation, known as **royalties**, may consist of a lump sum royalty or a royalty based on volume of production or sales.

Intellectual property licensing in the narrowest sense involves the sale or assignment of statutorily recognized rights of patents, trademarks, and copyrights to a foreign licensee or buyer. Intellectual property is usually expanded to include trade secrets. Trade secrets in the U.S. are protected under the common law. Technology transfer in its widest sense includes more than the licensing of IPR. It may include the transfer of technical know-how and skills, along with managerial processes and technical services or assistance. This chapter's coverage applies to both licensing and broader transfer scenarios.

IPR licensing may also be used to acquire foreign technology through **cross-licensing** agreements. With some patented inventions, opportunities may exist for cross-licensing among different aspects of a broader field of that invention, where each party grants a patent license to the other party, effectively allowing both parties to combine resources to exploit the full field of the patented technology. Cross-licensing arrangements may also relate to the creation of **patent pools** where multiple patent owners pool together their related patents covering a certain field for licensing to one another and to others who wish to participate. However, cross-licenses that are exclusive versus nonexclusive raise a greater risk of antitrust scrutiny from government authorities or challenges by other competitors excluded from the cross-licensing arrangement.

As a method of doing business, licensing has drawbacks; most importantly, the licensor loses control over its confidential information, know-how, and trade secrets. It risks losing its competitive advantage over competitors if the licensee or its employees disclose its information to others. Also, licensing produces smaller profits than directly exporting goods or services.

An associated issue, introduced in Chapter 18, is the importation of licensed goods into the licensor's market or what is popularly known as the **gray market** problem. A gray market problem exists when goods produced under a foreign license agreement are imported into the sales territory of the licensor or other licensees. The intellectual property licensing agreement must deal with the gray market issue, along with other areas of IPR protection. Gray market concerns will be addressed in the discussion of the grant clause and termination of licenses.

Technology licensing is not limited to the manufacturing sector. Franchising is also an important form of IPR licensing used by many service industries. Franchising is discussed in Chapter 3 on "Strategies for International Business" and Chapter 20 on "Foreign Direct Investment."

The law as applied to international intellectual property licensing is multilayered and complex.² Four areas of applicable law need to be analyzed: (1) whether home country law (law of licensor) applies extraterritorially (such as, patent, copyright, and trademarks recognized under its law), (2) whether an international convention can be used in protecting the property being transferred, (3) whether foreign host country's laws provide sufficient protection, and (4) whether host country laws exist that regulate the content of the licensing agreement. The first three areas were reviewed in Chapter 18; the fourth will be addressed in this chapter. The fourth area of law becomes especially important when the host country has a propensity for not protecting foreign IPR. In such countries, the restrictions placed in the licensing agreement may be the only means by which a licensor can protect its IPR.

Protecting Intellectual Property Rights

As a form of exporting, licensing has certain potential drawbacks. The negative aspects of licensing are weakened control over the rights because they have been transferred to an unaffiliated firm and fewer profits than would be generated by exporting goods or services. In certain countries, there are also problems of adequately protecting the licensed property from unauthorized use by third parties.

In considering the licensing of IPR, it is important to remember that foreign licensees may attempt to use the license to manufacture products to be marketed in third-party countries in direct competition with the licensor or its other licensees. In many instances, licensors will wish to impose territorial restrictions on their foreign licensees if permitted by foreign antitrust and licensing laws. Unauthorized exports to the U.S. by foreign licensees can sometimes be prevented by filing unfair trade practice complaints with the U.S. International Trade Commission under Section 337 of the **Tariff Act of 1930**.

In order to facilitate the denial of entry into the U.S. of unauthorized foreign imports, the licensor should record its copyrights, trademarks, and patents with the U.S. Customs Service. U.S. antitrust law, as a general rule, however, prohibits international IPR licensing agreements that unreasonably restrict imports of competing goods or technology. The U.S. Department of Justice's **Antitrust Enforcement Guidelines for International Operations** contains useful advice about the legality of various types of international transactions, including IPR licensing. In instances when significant federal antitrust issues are presented, U.S. licensors may wish to consider applying for a review from the Department of Commerce or request an **opinion letter** from the Department of Justice. The *Farrel Corporation v. International Trade Commission* case that follows illustrates the use of parallel proceedings to protect IPR rights. Farrel Corporation uses both public and private means against the infringing party. Its only strategic failure was improperly pursuing private litigation instead of arbitration as required by the licensing agreement.

Farrel Corporation v. International Trade Commission

949 F.2d 1147 (Fed. Cir. 1991)

Farrel manufactures and distributes worldwide heavy machinery used in mixing rubber and plastics. Pomini, an Italian company, also sells imported rubber and plastics processing machinery in competition with

Farrel. From 1957 until 1986, Farrel and Pomini entered into a series of licensing agreements allowing Pomini to manufacture, using Farrel's technology, and sell a line of rubber and plastics mixing machines worldwide, with

the exceptions of the United States, United Kingdom, and Japan.

The agreements included provisions requiring that Pomini return all designs, specifications, and other materials on the expiration of the contractual relationship. Each of the licensing agreements contained an arbitration clause requiring that “all disputes arising in connection with the present Agreement shall be finally settled by arbitration” through the International Chamber of Commerce.

On January 1, 1986, in accordance with the license provisions, Farrel terminated Pomini’s rights to use or to retain Farrel technology. Approximately seven months later, Pomini announced that it planned to enter the U.S. market and supply American customers with internal mixing devices and components it manufactured in Italy. Farrel later alleged that Pomini was only able to do this by using trade secrets that Pomini had misappropriated from Farrel. Farrel filed a complaint against Pomini in the Tribunal of Busto Arsizio, an Italian civil court, alleging the misappropriation of trade secrets and infringement of various patents and trademarks registered in Italy. A similar suit was filed in the Scottish Court of Sessions, in which Farrel alleged that Pomini infringed certain of its patents and trademarks registered in the United Kingdom. In both suits, Pomini asserted, as an affirmative defense, the “existence of binding arbitration agreements between the parties requiring that all disputes be resolved by an arbitration panel of the ICC.”

Meanwhile, on July 24, 1990, Farrel filed a complaint against Pomini with the U.S. International Trade Commission (ITC). It alleged that Pomini violated 19 U.S.C. §1337(a) in the importation of machines by misappropri-

ating trade secrets, committing trademark infringement, and falsely representing the manufacturer’s source. Farrel petitioned for an immediate cease and desist order under 19 U.S.C. §1337(f) and a limited permanent exclusion order forbidding entry into the U.S. of Pomini’s mixing devices. On October 3, 1990, the administrative law judge assigned to the case issued an initial determination terminating the investigation based on the existence of the arbitration clauses in the technology licensing agreements.

The ITC has exclusive authority to investigate, either on the basis of a complaint or on its own initiative, allegations that foreign importers are engaging in unfair methods of competition and unfair acts in the importation of articles. We conclude that the ITC acted contrary to law by terminating its investigation on the basis of an arbitration agreement without first determining whether a violation existed as required under Section 1337. REVERSED AND REMANDED.

Case Highlights

- The existence of an arbitration clause in a contract provides an affirmative defense against a party’s commencement of litigation.
- The U.S. **International Trade Commission (ITC)** has exclusive jurisdiction over the issuance of *cease and desist orders* preventing infringing foreign goods from being imported into the United States.
- The ITC must research the merits of claims of violations of the Tariff Act or intellectual property laws despite the existence of an arbitration agreement.

Before entering a foreign licensing agreement, it is important to investigate not only the prospective licensee but the licensee’s country as well. The government of the host country often must approve the licensing agreement before it goes into effect. Some governments, for example, prohibit royalty payments that exceed a certain rate or contractual provisions barring the licensee from exporting products manufactured with or embodying the licensed technology to third countries.

The prospective licensor should review the host country’s (country of the foreign licensee) patent, trademark, and copyright laws; exchange controls; product liability laws; antitrust and tax laws; and attitudes toward repatriation of royalties. The existence of a tax treaty or bilateral investment treaty between the U.S. and the prospective host country is an important indicator of whether the foreign country is investment and trade friendly.

Prospective U.S. licensors, especially of advanced technology, should also consider the need to obtain an *export license* from the U.S. Department of Commerce. Because of the potential complexity of international technology licensing agreements, firms should seek qualified legal advice in the U.S. before entering into such an agreement. In many instances, U.S. licensors should also retain qualified legal counsel in the host country in order to obtain advice on applicable laws. The next section reviews some of the due diligence issues that should be addressed by the international licensor of intellectual property before entering into a license with a foreign company.

Due Diligence

First a note of warning to the reader: Copyright, trademarks, and patents will be discussed intermittently throughout the rest of the chapter so be sure to concentrate on which type of IPR is being discussed in any given section or paragraph.

In contemplating the exportation of IPR, the licensor should undertake a **due diligence** review. Due diligence should provide answers to the following questions: (1) What formalities are needed to register or protect IP rights in the host country? (2) Will the transfer agreement or license need to be registered and approved by foreign government authorities? (3) What types of clauses are likely to be disapproved or violate foreign competition (antitrust) laws? and (4) Are there other mandatory legal rules that are specific to that particular country?

More specific host country laws include currency exchange controls, product liability laws, antitrust and tax laws, and restrictions on the repatriation of royalties and dividends. For example, foreign national and international IPR laws need to be reviewed in order to take the necessary steps to best protect the licensor's rights. Also, the licensor should review past transfers and infringement actions to determine the types of warranties and protections that it should place in the license agreement. A preventive law checklist should be developed to address these and other concerns (see Figure 19.1 *Doing Business Internationally*: "Due Diligence Checklist for Intellectual Property Transfers"). The checklist should be compiled and implemented by an intellectual property review team consisting of both legal and technical personnel.

A licensor's due diligence checklist should include the determination of whether the transfer agreement or license needs to be approved by an agency of the licensee's government. Some countries, unlike the U.S., require the **registration** of the license with a government agency. For example, in Russia all licensing agreements need to be registered. The failure to register the license results in the invalidation of the agreement. In addition, the licensee is prevented from being able to deduct royalty payments from a tax perspective.

As indicated in Chapter 18, the licensor should take all steps to protect its rights to trademarks and other IPR under the law of the licensee's country. Copyright is recognized globally, but patents and trademarks are territorial. Therefore, before entering any licensing agreement, the licensor should register its trademarks and patents under the appropriate foreign national laws. The rights to use the licensor's trademark should be expressly limited to the duration of the agreement. The rights should also be limited to the territory of the license grant and used only in reference to specific products.

The U.S. provides for protection of a trademark, registered or not, if that mark has become well known through domestic or international use (famous mark). In most countries, however, trademark rights are acquired only through registration and many countries require local use of the registered mark in order to maintain the registration. Whether a given mark can be registered in a particular country will depend on the law of that country. Some countries do not protect service marks. The U.S. is not a member of any agreement under which a single filing will provide international protection, although the right of priority under the Paris Convention confers a substantial benefit.

A company intending to expand internationally must decide early where it will need trademark protection by filing in those countries. Deciding where to file is a business issue in which a company balances the expense of registration against its benefit. At a minimum, a company will want to file in countries in which it plans on doing business. It is also prudent to file in countries that are known sources of counterfeit goods, although some national laws, as noted above, require local use to maintain a registration.

A trademark holder should also investigate the local connotation of a trademark or trade name before licensing with a foreign entity. A different language or culture may have unfavorable meanings for words or symbols with neutral or favorable meanings in the U.S. Even packaging colors may connote different meanings in different countries. For example, white often implies purity in the U.S., but it is the color of mourning in most of the Far East.

Special attention should be given to the protection of **trade names**. In the U.S., state incorporation statutes protect trade names. In the process of incorporating, a company reserves a corporate name. Such a reservation prevents anyone else from using a similar name when incorporating. The problem is that trade names are not well protected under some foreign incorporation laws. In a number of countries there is no explicit prohibition against a

<p style="text-align: center;">Intellectual Property Review Team</p> <p>Assemble an intellectual property review team. This team should include representatives from: management; local and foreign legal counsel; technical personnel, such as representatives from research and development, engineering, and production; sales and marketing; human resources; and possibly financial.</p>	
<p style="text-align: center;">Patents</p> <ul style="list-style-type: none"> • What are the terms remaining on the patents? • Have patents been used in countries that require <i>working</i>? • Identify all U.S. and foreign patents associated with the transfer. • Search U.S. and foreign patent office records for title and payment of all necessary fees. • Identify other research and development projects, which may be exposed to competition in the event of a transfer. • Identify procedures for protecting inventions, including procedures for determining whether an invention should remain a trade secret, making foreign filing decisions, and ensuring the timeliness of patent filings. • Determine which patents cover which products. • Identify all markings to be used in conjunction with the production of the licensed product. • Identify all existing and pending agreements dealing with the patents. • Whether a licensor or licensee, always ask: Are the patents or licenses transferable? Are improvements included in the transfer? • Are there any non-compete provisions? What are the termination dates on the patents and licenses? Are there any security interests (liens) on file with the U.S. Patent Office and have applicable state records been reviewed? • Review all correspondence relating to patent disputes, claims of infringement, and letters threatening lawsuits or other notices received by licensor or licensee. • What steps have been taken to insure patent rights in the foreign country of the licensee or the geographic area of the license grant? Has the patent been registered under the appropriate foreign national law? 	
<p style="text-align: center;">Trademarks</p> <ul style="list-style-type: none"> • Identify all federal, state, and foreign trademark registrations and pending applications. • Check title and payment of renewal fees. • Identify all procedures for protecting trademarks, including procedures for deciding whether to seek registrations. 	
<ul style="list-style-type: none"> • Determine the products on which each trademark is used. Provide licensee with sample of the proper use of the trademarks. • Review copies of all product advertising and promotional materials. • Check use of the trademark on the Internet. • Has there been any period of nonuse of the trademarks? • Have there been any previous assignments of the trademarks? Have these assignments been recorded? • Are the trademarks and any licenses pertaining to them transferable or assignable? Are there any restrictions or limitations in the licenses? • Check for security interests with the U.S. Trademark Office and applicable state records, and conduct comparable foreign searches. • How has the licensor and licensee protected their trademarks in the past? • Review renewal dates on trademarks. 	
<p style="text-align: center;">Copyrights</p> <ul style="list-style-type: none"> • Identify all copyrighted materials associated with the transfer or license. • Check title to copyrights and payment of renewal fees for copyrights by searching the U.S. Copyright Office. • Review procedures for identifying “copyrightable” material, and the protecting of those materials, including procedures for deciding whether to mark materials or to register them. • Review all agreements dealing with the copyrights. Are they assignable or transferable? Are there any restrictions or limitations on their use or transfer? • Check for security interests by searching the U.S. Copyright Office and state records. • Have the licensor and licensee enforced their copyrights in the past? • Does any action need to be taken in the country of the licensee to protect the copyrights? 	
<p style="text-align: center;">Miscellaneous</p> <ul style="list-style-type: none"> • What procedures should the licensee be required to undertake in order to protect the rights being licensed? Review site security, employee access, and monitoring of third parties. • Review employment agreements relating to intellectual property and confidentiality. Does the licensee conduct employee exit interviews? • What procedures and responsibilities should the licensee be required to undertake in relationship to third-party infringements? 	

Figure 19.1 *Doing Business Internationally*: Due Diligence Checklist for Intellectual Property Transfers.³

new company using or modifying the name of a preexisting company. Therefore, the license agreement should address the issue of the licensee’s use or modification of the licensor’s trade names. For example, any registration of the trade name should inure to the benefit of the licensor.

More and more companies are taking aggressive, self-help approaches to deterring the counterfeiting and piracy of their intellectual property. One approach is to establish **Brand Protection Units** inside the country where the piracy and counterfeiting is being done. See Figure 19.2 *Doing Business Internationally*: “Brand Protection Units (BPU).”

Features	
Manager of BPU comes from Corporate Security Department. BPU Manager reports to Brand Manager or General Manager. BPU coordinate their activities with Chinese authorities.	BPU may seek assistance of private investigators. Goal is to identify and locate source of counterfeited goods. Location of counterfeiters is not revealed to Chinese authorities until the raid is in progress. A member of the BPU or company should be present at the raid in order to identify the illegal goods.

Figure 19.2 *Doing Business Internationally*: Brand Protection Units (BPU).⁴

This strategy has become common for companies doing business in China. In short, these units are essentially private police or private investigators who work with the Chinese authorities. The fact that the authorities are willing to conduct raids shows the problem in China is not due to a lack of laws, but is due to the enforcement of those laws and that the lack of enforcement is at least partially due to the lack of manpower.

Another strategy has been to find the counterfeiters and enter into licensing agreements with them. This may seem like rewarding illegal or criminal activities, but may be the best practical solution due to the costs and uncertainty in pursuing legal actions. Professor Chow argues that the problem of counterfeit goods is overblown in that many purchasers of such goods do not have enough money to buy the authentic good so the IPR owner is not actually losing sales or royalties. This is likely the case for luxury items like expensive Swiss watches, where the buyer paying \$40 dollars for a “Rolex” watch knows that she is not buying a genuine Rolex. However, with lower-end products, especially where quality concerns are not as pronounced, such as with compact discs or DVDs, counterfeiting and piracy remain serious problems.

Intellectual Property License Registration

National laws determine the formalities of preserving and transferring IPR. In the U.S., even though copyrights are automatically protected at the moment of creation, better protection can be achieved by registering them with the appropriate government office. In the area of licensing, compliance with formalities is especially important. The **U.S. Copyright Act** also allows for the registration of licenses in the Copyright Office. Such registration provides the licensee with important benefits. Section 205 of the Act provides that the recording of copyright transfers constitutes constructive notice of the facts stated in the recording. This becomes important in the event that the copyright owner transfers two conflicting licenses. Section 205(d) states that the license that is recorded first will prevail even against licenses that were granted at an earlier date.

Section 204(a) of the Copyright Act states that a transfer of copyright ownership is not valid unless the instrument of transfer is in writing and signed by the owner. “Transfer of copyright ownership” is broadly defined to include the granting of an **exclusive license**. Thus, both an assignment of all the owner’s intellectual property rights and a license of less than total rights need to be in writing.

The formalities of copyright transfers or licenses are explored in the *Valente-Kritzer Video v. Callan Productions* case that follows. The case also introduces the concept of how U.S. federal intellectual property statutes preempt other causes of action brought by licensees.

Valente-Kritzer Video v. Callan Productions

881 F.2d 772 (9th Cir. 1989)

Sneed, Circuit Judge. Valente-Kritzer Video (VKV) produces video programming for sale and distribution. Callan Pinckney is the author of a best-selling book

entitled Callanetics. VKV offered to produce a home video based on Pinckney’s book. VKV alleges that the parties entered into an oral agreement whereby VKV

“was given the exclusive right to shop for a home video deal and to negotiate with major home video cassette manufacturer and distributors for the production and distribution of a home video based upon the book.”

Pursuant to the agreement, VKV arranged with MCA Home Video, a nationally recognized producer of home videocassettes, to produce the video. Pinckney, however, refused to perform her part of the agreement. Ultimately, Pinckney and MCA agreed to produce the videocassette that was a commercial success. VKV then filed this action for breach of contract, tortious breach of contract, and fraud. Pinckney moved for summary judgment (dismissal), arguing that the Copyright Act of 1976 preempted all of VKV’s claims.

A. Breach of Contract

We first address VKV’s action for breach of contract. This claim encounters, as VKV concedes, the requirement that a contract transferring an exclusive license in a copyrighted work be in writing. If an oral transfer of a copyright license is later confirmed in writing, the transfer is valid. The right to prepare a derivative work, such as a videocassette based on a copyrighted book, is one of the exclusive rights comprised in a copyright. Section 204(a) not only bars copyright

infringement actions but also breach of contract claims based on oral agreements.

B. Fraud

VKV’s final argument is that the district court improperly held that the Copyright Act preempted the claim for fraud. The district court held that VKV’s fraud claim is substantially equivalent to the rights afforded to owners and exclusive licensees of copyrighted works under the Copyright Act, and therefore such a claim is preempted. We believe that the district court carried preemption too far in this instance. Two district courts have held that common law fraud is not preempted. In its complaint, VKV does allege the element of misrepresentation that distinguishes this claim from one based on copyright.

Case Highlights

- A transfer of copyright ownership is not valid unless the instrument of transfer is in writing and signed by the owner.
- “Transfer of copyright ownership” is broadly defined to include the granting of an exclusive license.
- Certain claims, such as common law fraud, are not preempted by the Copyright Act.

Intellectual Property Licensing Agreement

Once a patent, copyright, or trademark is obtained, the holder is free to assign, transfer, or even mortgage those rights. The licensing agreement is the most common means of transfer. The intellectual property agreement or license takes on added significance in international transfers as compared to purely domestic transfers in the U.S.

Most jurisdictions require *exclusive copyright licenses* to be in writing, typically signed by at least the licensor. Nonexclusive licenses, on the other hand, typically need not be in writing and many jurisdictions recognize open and Creative Commons–style licenses. Few jurisdictions require copyright licenses to be filed or registered. Different jurisdictions have different requirements about whether a *trademark license* agreement must be in writing. U.S. law does not require any written agreement; whereas certain European countries require license agreements to be in writing and signed by the licensor.

The intellectual property agreement or license takes on added significance in international transactions as compared to purely domestic transfers in the U.S. The wide variety of intellectual property protections offered by foreign laws requires the American exporter of technology to take added precaution in drafting a contract that is protective of its IPR. It is important that the contract provide avenues for lawsuits for breach of contract where an infringement claim is unlikely to be sustained under a foreign intellectual property law regime.

Following the identification of the parties, the generic licensing agreement will have a number of **recitals** and a definitional section. The recitals will often list the rights being licensed. Any untruthful recitals can become the basis for lawsuits asserting breach of warranty or misrepresentation. The licensor should verify the status of all its trademarks, copyrights, patents, and any patents pending. Extra care should be taken in defining terms in the definitions section. Given the differences in language, culture, and national intellectual property regimes, the agreement should possess a carefully negotiated and drafted list of definitions. For example, the meaning of terms

such as “net sales” or “gross sales” for the purposes of calculating royalties will often be at the center of disputes if they are not carefully defined.

The root of the intellectual property transfer agreement is the **grant clause**, which describes the rights and know-how being transferred, along with any restrictions or limitations on their use. The grant clause should itemize all the intellectual property rights and know-how being transferred. The grant should make clear whether the license is exclusive or nonexclusive. The difference is fundamental to issues regarding the degree of competition that may be expected by the licensee and in the setting of the royalty rate. The grant clause will be examined in more detail in the next section.

Exclusivity is interconnected to issues dealing with infringement. In an exclusive license, the licensee should negotiate the right to demand that the licensor sue any third-party infringer or in the alternative, be given the right to sue in the name of the licensor for any infringements in the license territory. A nonexclusive license grant may include a **most-favored license clause** in which the licensor is required to amend the license to include the more favorable terms negotiated in a subsequent license given to another licensee. This would insure that earlier licensees are not placed in an unfair competitive disadvantage.⁵ The problem with such clauses is the difficulty in determining the relative values of different terms. All things being equal, the negotiation of a more favorable royalty rate would be considered to be subject to a most-favored license clause. A well written most-favored license clause would require the licensor to notify the licensee of any new licenses affecting its territory and to provide a copy of any such licenses so that the licensee can determine if the terms of the other license are more favorable. Finally, the most-favored license clause should provide that if the licensee demands an amendment to its license in order to incorporate any more favorable terms, it must also accept the less favorable terms included in the subsequent license.

The licensing of technology, IPR, and know-how involves some of the more complicated and detailed contracts found in international business transactions. Some of these restrictions will be discussed in the last section of this chapter. These few sections will analyze the content of such agreements. The issue of the enforceability of these clauses will be addressed later in the chapter.

Common Licensing Clauses

Because the licensing of IPR is a private contract, the parties are free to formulate their contract as they wish. In case of a subsequent dispute, the courts and arbitration panels will look initially to the contract to determine the respective duties and rights of the parties. It is important to note, however, that the licensing agreement is regarded as a *sui generis* or unique type of contract. Competition (antitrust) laws, for example, will preempt the operation of overly broad territorial restrictions or tying provisions in a licensing agreement.

In most developing countries, certain license clauses are limited by a variety of specific **technology transfer laws**. Unlike competition law, the aim of technology transfer laws is not to protect competition, but to improve the bargaining strength of the licensee and to promote local technological development. The government approval authorities will examine the contract to see if they are too one-sided in favor of the licensor. The clauses that are most closely examined include the confidentiality, grant back, choice of law, export restrictions clauses, and clauses limiting the licensee’s use of the technology after the termination of the license. For example, a **duration clause** will often prohibit the use of know-how after the termination of the term of the contract. A technology transfer law may eliminate such a restriction and convert the so-called license into an outright sale. A **grant-back clause** that requires any improvement of the technology made by the licensee to be assigned back to the licensor is considered invalid under some technology transfer laws. Most countries will allow a grant-back clause that is reciprocal or nonexclusive. In a reciprocal grant-back clause improvements made by either the licensor or licensee are to be shared with the other party. The grant-back clause will be examined in more detail later in this chapter. A **confidentiality clause** restricts access to the technology to a limited number of **key personnel** of the licensee and prohibits any further disclosure of confidential information to third parties. Many licensors will require licensees to have all their employees sign separate confidentiality agreements. Most developing countries will insist on a broader dissemination of the technology to their citizens. Therefore, they will often limit the scope of

confidentiality clauses and agreements. A **choice of law clause** and **forum selection clause** that designate the law of the licensor and the licensor's country as the place of dispute resolution are likely to be disregarded by the courts in a developing country. The courts in a developing country will generally decide that the transfer agreement be subject to the jurisdiction and law of the host country.

In addition, most licensors will desire strict territorial provisions limiting the licensee to selling only in the territory specified in the license. An *export restriction clause* is generally inserted to prevent a gray market problem from developing. Such restrictions on export may be invalidated under foreign competition law, such as in the European Union, or under technology transfer laws found in many developing countries. Generally, developing countries aggressively promote the export of goods in order to acquire hard currencies and to improve their balance of trade. See Figure 19.3 *Focus on Transactions*: "Explanations of Common License Clauses" for examples and purposes of some other common license clauses.

Foreign competition, technology transfer, and consumer protection laws cannot be avoided through contractual agreement. For example, some foreign contract or consumer laws limit the scope of disclaimers or limitation of liability clauses. Thus, it is imperative that the international licensor determine how such laws, along with differences in customs and trade usage, will impact the operation of their standard licensing agreements. The following sections focus upon some of the standard clauses found in intellectual property agreements.

Compliance with Export Laws

"The licensed products shall not be exported, directly or indirectly, in violation of the export regulations of the United States or be used for any purposes prohibited by the export regulations." In this clause, the licensee agrees to comply with the export regulations of the licensor's country.

Merger or Integration Clause

"This contract supersedes the terms of any purchase order or ordering document, along with the terms of any unsigned or 'shrinkwrap' license included in any product package." This clause is especially important where the individual products being transferred come with their own licenses. The licensor would want to supersede such "individual licenses" only if it has provided adequate terms in the master license or transfer agreement.

Limitation of Liability

"The provisions of this Agreement allocate the risks between the licensor and licensee. The licensor's pricing reflects this allocation of risk and the limitation of liability hereto specified." The parties will generally want to exclude liability for indirect, incidental, special, or consequential damages. The licensor may want to limit the extent of its liability to an amount no greater than the total fees paid by the licensee.

Exclusive Remedy Clause

"The licensee's exclusive remedy and the licensor's total liability shall be the correction of defects in the licensed product or the reperformance of services rendered. Upon failure by the licensor to correct the defects within a reasonable period of time, the licensee may terminate the license and recover any fees paid for the product or for the unsatisfactory services." An ancillary

clause to the limitation of liability clause is one that limits the types of remedies available to the parties.

Infringement Indemnity Clause

"Licensor will defend and indemnify licensee against claims of infringement of patent, copyright, or other intellectual property rights provided that (a) the licensee notifies licensor in writing within 45 days of receiving the claim, (b) the licensor shall have full control over the defense of the claim, and (c) the licensee shall assist the licensor in defending the claim. The licensor shall reimburse the licensee for reasonable expenses incurred in providing such assistance. The licensor shall have the option to (a) modify the licensed products to make them noninfringing or (b) obtain a valid license for the licensee. If the licensor determines that it is not commercially reasonable to perform either (a) or (b), then the licensor may terminate this license and refund the license fees. This shall be licensor's entire liability and the licensee's exclusive remedy for third-party claims of infringement." The licensee will want assurance that the licensor will defend it against any infringement claims. In turn, the licensor will want to limit its exposure to defending such claims.

Most-Favored License Clause

The licensor is required to notify and offer more favorable terms given to other licensees in the future to ensure that the favored licensee remains on an equal competitive footing with other licensees. Such a clause requires the licensor to provide the same royalty rate and terms to the licensee that he subsequently gives to another competitive licensee. Such a clause is likely to place the burden in future litigation on the licensor to prove that the most-favored licensee's competitor was not given a license at a more favorable or lower royalty rate.

Figure 19.3 *Focus on Transactions*: Explanations of Common License Clauses.

License Grant and Limitations

As noted previously, the single most important clause in any intellectual property, technology, or software licensing agreement is the **grant clause**. It describes the rights and know-how being transferred, along with any restrictions or limitations on their use. The licensor will want to emphasize that it is granting to the licensee only the right to use the items being transferred. The grant clause should limit or prohibit the licensee's right to copy the licensed material; clearly state that the licensor retains all title, copyright, patents, and other proprietary rights; and require the licensee to cease using the information upon termination and for the return or destruction of all copies.

The grant clause should also define the grant in terms of its geographic scope, as well as its duration. If the license is for the right to produce, sell, and use the rights in the U.S., then the Patent Act implies that the grant territory is the entire U.S., along with its possessions and territories.⁶ If the license is silent as to duration, then a court may imply that it was intended to grant rights for the entire statutory term of the patent, copyright, or trademark.⁷ The grant clause may also restrict the nature of the rights being transferred. For example, for technology with different **fields of use**, the grant clause may restrict the type of use for which the transferred rights are to be utilized. For example, the patent owner of laser technology may elect to license the technology separately in the fields of medicine, industry, and government armament or defense. The *Mallinckrodt, Inc. v. Medipart, Inc.* case that follows provides an example of a field of use restriction. It also demonstrates that the licensor has the right to sue not only the licensee for violating a grant restriction, but also a third party who assists the licensee in committing the violation. The third party that assists a licensee in the violation of a patent license can be sued for **inducement to infringe**.

In addition to the field of use and territorial scope issues, parties to a patent license agreement may wish to further divide the scope of the grant into the various rights granted under the patent laws of the relevant jurisdictions. For example, a patent licensor may wish to grant one licensee the exclusive right to make or manufacture the patented invention, while granting another licensee the exclusive right to distribute or sell the invention to retailers or end users.⁸

Mallinckrodt, Inc. v. Medipart, Inc.

976 F.2d 700 (Fed. Cir. 1992)

Newman, Circuit Judge. This action for patent infringement and inducement to infringe relates to the use of a patented medical device in violation of a "single use only" license that accompanied the sale of the device. Mallinckrodt sold its patented device to hospitals, which after initial use of the devices sent them to Medipart for servicing that enabled the hospitals to use the device again. Mallinckrodt claimed that Medipart thus induced infringement by the hospitals and also directly infringed the patent. The device is marked with the appropriate patent numbers, and bears the trademarks "Mallinckrodt" and "UltraVent" and the inscription "Single Use Only." The package insert provided with each unit states "For Single Patient Use Only" and instructs that the entire contaminated apparatus be disposed of in accordance with procedures for the disposal of biohazardous waste. Instead, the hospitals shipped the used manifold-nebulizer assemblies to Medipart, Inc. The "reconditioned" units, as Medipart calls them, are shipped back to the hospitals from where they came.

Mallinckrodt filed suit against Medipart, asserting patent infringement and inducement to infringe. The district court granted Medipart's motion on the patent infringement counts, holding that the "Single Use Only" restriction could not be enforced by suit for patent infringement. The court also held that Medipart's activities were permissible repair, not impermissible reconstruction, of the patented apparatus. Mallinckrodt states that the restriction to single patent use is valid and enforceable under the patent law and the restriction does not enlarge the patent grant.

Restrictions on use are judged in terms of their relation to the patentee's right to exclude from all or part of the patent grant, and where an anticompetitive effect is asserted, the rule of reason is the basis of determining the legality of the provision. To sustain a misuse of patent defense involving a licensing arrangement, a factual determination must reveal that the overall effect of the license tends to restrain competition unlawfully in an appropriately defined relevant market.

The district court stated that it intimated no opinion as to whether Mallinckrodt might enforce the restriction on “contract law or property law” or on “equitable grounds.” We agree that a patentee may choose among alternate remedies, but to deny a patentee access to statutory remedies is to withhold the protection of the law. Thus whether Mallinckrodt may also have a remedy outside of the patent law is not at issue.

The appropriate criterion is whether Mallinckrodt’s restriction is reasonably within the patent grant, or whether the patentee has ventured beyond the patent grant and into behavior having an anticompetitive effect not justifiable under the rule of reason. We conclude that the district court erred in holding that the restriction on reuse was, as a matter of law, unenforceable under

the patent law. The grant of summary judgment is REVERSED.

Case Highlights

- A license grant may restrict the licensee to a “single patent use.”
- A third party that provides a service that allows a licensee to avoid restrictions found in its patent license is guilty of “induced infringement.”
- A patent owner has the right to exclude others from using its invention. Therefore, it has the right to place use restrictions in licensing its patent, unless the restrictions have an unreasonable anticompetitive effect.

A major issue that should be addressed in the license is the right of the licensee to export goods from the licensed territory. Of great concern is the licensee’s ability to import goods into the country of the licensor. This **gray market** problem has become hotly contested throughout the world. If the mobility of the goods being produced under the license is a concern for the licensor, then it should place restrictions in the license in order to prevent gray market imports. The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) grants the licensor or intellectual property owner the rights to prevent imports of licensed goods into its domestic market. These additional rights should be clearly delineated in the agreement.

Another method for minimizing gray market risks is for the licensor to negotiate caps on the maximum number of units of the licensed product the licensee can produce in a given year. The overall cap could be determined by calculating an estimate of sales expected for the licensed territory based upon its demographics or based upon sales figures of similar territories. The licensor could also limit the number of units that the licensee may sell to individual purchasers. This should include placing a “due diligence” duty upon the licensee to investigate a third-party purchaser, especially in large-volume sales. In addition, the license should state that the licensee is precluded from selling to anyone who is known to export goods into other markets.

In attempting to describe the scope of uses granted by the license, the grant clause may fail to anticipate future unforeseen uses of the intellectual property. This was the issue addressed by the court in *Cohen v. Paramount Pictures Corp.* In such cases, the court must determine whether the unforeseen use comes within the spirit of the license grant.

Cohen v. Paramount Pictures Corp.

845 F.2d 851 (9th Cir. 1988)

Hug, Circuit Judge. This case involves a novel issue of copyright law of whether a license conferring the right to exhibit a film “by means of television” includes the right to distribute videocassettes of the film. We hold it does not. Herbert Cohen is the owner of the copyright in a musical composition entitled “Merry-Go-Round.”

Cohen granted H & J Pictures, Inc., a “synchronization” license, which gave H & J the right to use the composition in a film called *Medium Cool* and to exhibit the film in theatres and on television. Subsequently, H & J assigned to Paramount Pictures all of its rights, title, and interest in the movie *Medium Cool*, including all of the

rights and interests created by the license from Cohen to H & J. Sometime later, Paramount furnished a negative of the film to a videocassette manufacturer, who made copies of the film—including a recording of the composition—and supplied the copies to Paramount. Paramount, in turn, sold approximately 2,725 videocassettes of the film, receiving gross revenue of \$69,024.26 from the sales.

On February 20, 1985, Cohen filed suit against Paramount in federal district court alleging copyright infringement. Cohen contended that the license granted to H & J did not confer the right to use the composition in a reproduction of the film in videocassettes distributed for home display.

To resolve this case, we must examine the terms of the license, in order to determine whether the license conveyed the right to use the composition in making and distributing videocassette reproductions of *Medium Cool*. The document begins by granting the licensee the “authority to record, in any manner, medium, form or language, the words and music of the musical composition and to make copies of such recordings and to perform said musical composition everywhere, all in accordance with the terms, conditions, and limitations hereinafter set forth.” It further states: “The license herein granted to perform said musical composition is granted for: (a) The exhibition of said motion picture to audiences in motion picture theatres and other places of public entertainment where motion pictures are customarily exhibited and (b) The exhibition of said motion picture by means of television, including ‘pay television,’ ‘subscription television,’ and ‘closed circuit into homes’ television.” Finally, another provision states that the license reserves to the grantor “all rights and uses in and to said musical composition, except those herein granted to the Licensee.”

Although the language of the license permits the recording and copying of the movie with the musical composition in it, in any manner, medium, or form, nothing in the express language of the license authorizes distribution of the copies to the public by sale or rental. One of the separate rights of copyright, as enumerated in section 106 of the Copyright Act, is the right “to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending.” Thus, the right to distribute copies of the videocassettes by sale or rental remained with the grantor under the *reservation of rights provision*.

It is obvious that the distribution of videocassettes through sale and rental to the general public for viewing in their homes does not fit within the purpose of the license grant that is restricted to showing in theatres and other similar public places. Paramount argues that distribution of videocassettes for showing in private homes is the equivalent of “exhibition by means of television.” The words of that paragraph must be tortured to expand the limited right granted by that section to an entirely different means of making that film available to the general public—the distribution of individual videocassettes to the general public for private “performances” in their homes. Television and videocassette display have very little in common besides the fact that a conventional monitor of a television set may be used both to receive television signals and to exhibit a videocassette. Moreover, the license must be construed in accordance with the purpose underlying federal copyright law.

Courts have repeatedly stated that the Copyright Act was “intended definitively to grant valuable, enforceable rights to authors and publishers to afford greater encouragement to the production of literary works of lasting benefit to the world.” We would frustrate the purposes of the Act were we to construe this license—with its limiting language—as granting a right in a medium that had not been introduced to the domestic market at the time the parties entered into the agreement.

We hold that the license did not give Paramount the right to use the composition in connection with videocassette production and distribution of the film *Medium Cool*. The district court’s award of summary judgment in favor of Paramount is REVERSED.

Case Highlights

- In determining the scope of the grant clause, courts will examine any relevant terms of the license for guidance.
- The Copyright Act reserves all rights, whether or not they existed at the time of the creation of the work, to the creator of the work (copyright owner).
- Expanding a license grant to include the application of the licensed property to a medium that had not been developed at the time of the execution of the license would frustrate the purpose of the Copyright Act (protecting the rights of the creator of works).

Review of Typical License Agreement

A number of contract provisions are found in most generic intellectual property licensing agreements. When reading this section, the student should bear in mind the following questions: (1) What issues are being dealt with in the clauses? (2) What issues are being neglected? (3) How can the clauses be rewritten for added clarity? and (4) How can the clauses be made more pro-licensor or pro-licensee? In order to address these concerns the reader should draw upon the materials in this chapter and in Chapter 18. See Figure 19.4 *Doing Business Internationally: "Examples of License Clauses."* These sample clauses are generally written from the perspective of the licensor. Problem 6 of the Chapter problems ("License Writing and Review Problem") provides another opportunity to review and write license clauses.

In a **licensed territory clause**, the licensor defines the appropriate sales areas or distribution channels for the licensed product. "Licensed product" refers to the products to be produced or sold under the authority granted by the agreement. If the license grants "exclusive" territory, then the licensor cannot grant other licensees the right to sell in the exclusive territory. The licensor will generally want to restrict the licensee's ability to sell products outside the licensed territory.

Another clause that attempts to limit the licensee's ability to compete against the licensor is the **covenant not-to-compete**. Much like U.S. courts, foreign courts highly scrutinize and limit these types of clauses. The licensor will often require such a clause in order to prevent the licensee from competing against it after the termination of the license agreement. Article 2596 of the Italian Civil Code typifies the restrictions placed upon covenant not-to-compete clauses. It requires that such clauses be in writing, be limited to a certain geographical area and activity, and not exceed five years in duration. Italian courts generally favor the licensee in narrowing the restrictions pertaining to area and activity.

In the **reservation of rights clause**, the licensor reserves any IP or contractual rights not expressly transferred by the license. This reservation should always be inserted, even if the license is intended to be exclusive.

The improvements or **grant-back clause** attempts to reserve to the licensor future rights of any subsequent improvements made by the licensee in the licensed property. "Licensed property" refers to the IPR being transferred under the agreement. The licensor will want to stipulate that any modifications or improvements made by the licensee shall revert to the ownership of the licensor. The clause often requires the licensee to assign to the licensor all its rights to any modification.

The grant-back clause should deal with two distinct issues: (1) ownership of the improvement and (2) the right to use the improvement. A one-sided, nonreciprocal grant-back clause, which gives all rights, title, and the right to use any improvements made by the licensee to the licensor, is not enforceable in some countries. In contrast, non-reciprocal grant-back clauses are generally enforced in U.S. courts unless they are held to violate the antitrust laws.⁹ Depending upon the country, it may be necessary to provide for reciprocity or sharing within the grant-back clause; any subsequent improvements made by the licensor may also have to be made available to the licensee.

One technique for increasing the likelihood that a grant-back clause will be enforced is to provide for reasonable compensation for the grant back of the licensee's improvements. Also, the grant back can be made nonexclusive. A nonexclusive grant back allows the licensee to continue to use its improvement within the geographical scope of the license.

The licensee generally pays for the licensed property through royalty payments. The **royalty clause** is negotiated along three general parameters: the royalty rate, guaranteed consideration, and momentum royalties. A generic royalty rate is based upon a percentage of sales, determined in one of two ways. The use of gross sales generally favors the licensor, while using net sales favors the licensee. The distinction between use of gross sales and net sales is not always significant, however. A net sales definition that allows for very few offsets or deductions will result in a figure very close to a gross sales amount. Conversely, a gross sales definition that allows for a liberal number of setoffs can result in a figure that mimics a net sales figure.

Guaranteed consideration may be a schedule of payments, including a good faith deposit, not connected with sales by the licensee. Guaranteed consideration ensures that the licensee will make reasonable efforts to produce,

Royalties

“Guaranteed Consideration”: The sum of \$ _____ is payable upon the following dates: _____. These sums as set forth above shall be applied against such royalties as become due to the licensor. No part of such Guaranteed Consideration shall be repayable to the licensee. “Royalty Payments”: The Royalty Rate shall be five percent (5%). The licensee shall pay a sum equal to the Royalty Rate of all “net sales” by the licensee of the Licensed Product. The term “net sales” shall mean gross invoice price billed customers, less actual quantity discounts and actual returns (actual returns not to exceed 5%).

Accounting and Record-keeping

Within thirty days of the end of every month, the licensee shall furnish to licensor complete and accurate statements certified by an officer of the licensee with respect to the number of units sold, their gross sale prices, and itemized deductions from the gross sale prices.

The licensee shall maintain and preserve records pertaining to the license at its principal place of business for at least two years following termination or expiration of the license term or any renewals. These records shall include, without limitation, purchase orders, inventory records, invoices, correspondence, banking and financial records, and any other records pertaining to the Licensed Products. Such records and accounts shall be available for inspection and audit at any time during or after the license term during reasonable business hours and upon at least three (business) days written notice by the licensor.

Indemnification

The licensor shall indemnify the licensee and hold it harmless from any loss or liability arising out of any claims brought against the licensee by reason of the breach by the licensor of the warranties and representations stated within this License Agreement. The licensee shall indemnify the licensor and hold it harmless from any loss or liability arising out of any claims brought against the licensor by reason of the licensee’s breach of any provision of this License Agreement including any unauthorized use by the licensee, any improper use of trademarks, copyright, patent, design, or process not specifically granted or approved by the licensor, any noncompliance by the licensee with laws or regulations, and for any defects attributable to the licensee’s production of the Licensed Products.

Quality Control

The licensee agrees to strictly comply and maintain compliance with the quality standards, specifications, and rights of approval of the licensor in respect to any and all usage of the Licensed Property. Any modification of the Licensed Product must be submitted in advance for the licensor’s written approval as if it were a new product.

Licensor Warranties

The licensor warrants that it possesses the right to license the Licensed Products, including any patents, copyrights, or trademarks, in accordance with the provisions of this License Agreement. The making of this License Agreement does not violate any agreements or rights of any other person, firm, or corporation.

Licensee Warranties

The licensee warrants that it will not harm, misuse, or bring in disrepute the Licensed Property. The licensee will manufacture, sell, and distribute the Licensed Products in accordance with the terms of this License Agreement, and in compliance with

applicable government regulations and industry standards. Upon reasonable notice, the licensee shall permit the licensor to inspect testing records and procedures with respect to the production and sales of the Licensed Products for compliance with applicable quality standards provided in this License Agreement and for compliance with applicable governmental, regulatory, industry, and certification standards.

Confidentiality

The licensee warrants that it will use its best efforts to maintain the confidential nature of all proprietary information and to prevent unauthorized access, reproduction, use, or disclosure of that information. It will restrict access to key employees on a need-to-know basis. In furtherance of this obligation it shall: (a) maintain all copyright notice, trademark notice, and other proprietary markings and (b) not copy or reproduce the proprietary information except as authorized under this agreement.

Copyright and Trademark Protection (Infringement)

The licensee shall cause to be imprinted on each Licensed Product sold under the License Agreement, and on all advertising, promotional, and packaging material, the proper copyright notices and trademarks as instructed by the licensor. The licensee shall promptly notify the licensor in writing of any infringements by others of the Licensed Property. The licensee shall assist the licensor at the licensor’s expense in the procurement, protection, and maintenance of the licensor’s rights in the Licensed Property. The licensee agrees to cooperate with the licensor in connection with any claims or suits relating to infringements on the licensor’s property rights.

Assignment and Sublicensing

This License Agreement is personal to the licensee. The licensee shall not sublicense, franchise, assign, or delegate to third parties any of the rights acquired hereunder. Neither this License Agreement nor any of the rights hereunder shall be sold, transferred, or assigned by the licensee.

Independent Contractor

The licensee is an independent company. Nothing in this agreement is intended to represent that the licensee is to act as an agent or partner of the licensor. The licensee is not granted any rights or authority, express or implied, to bind the licensor in any manner.

Termination

The licensor shall have the right to terminate this Agreement without prejudice to any rights which it may have upon the occurrence of any of the following events: (1) The licensee fails to deliver or maintain the required product liability insurance policy, (2) The licensee becomes delinquent on any payments due under this License Agreement, (3) The licensee fails to provide access to the premises or access to the records required to be maintained under this License Agreement, (4) The licensee fails to comply with applicable laws, regulations, or industry standards, (5) The licensee does not commence in good faith to manufacture, distribute, or sell the Licensed Products throughout the Licensed Territory, and (6) The licensee delivers or sells Licensed Products outside the Licensed Territory or knowingly sells Licensed Products to a third party who the licensee knows intends to or reasonably should suspect intends to sell or deliver such Licensed Products outside the Licensed Territory.

Figure 19.4 *Doing Business Internationally*: Examples of License Clauses.

market, and sell the licensed product. The licensee should negotiate that any advance payments (“Guaranteed Consideration”) are to be credited against future royalties.

Momentum royalties are paid when the licensee sells other product lines. These royalties are based upon increases in the licensee’s overall sales. This notion is similar to the rental provisions in commercial leases that base the rent on the tenant’s sales. Momentum royalties are negotiated in licenses of marquee products that are likely to draw customers to the licensee’s other products.

One type of license that creates special problems in drafting the royalty clause is the **hybrid license**. A hybrid license includes patent use rights, along with some other IPR not of the same type or duration as the patent being licensed. One issue that has been disputed is whether the license may provide for payment of royalties past the expiration of the patent.

The U.S. Supreme Court in *Brulotte v. Thys Co.*¹⁰ held that an agreement that extends royalties beyond the life of a patent is *per se* unenforceable. Therefore, royalty clauses must be carefully written to avoid invalidation because of post-expiration royalties. In order to avoid invalidation of royalties in a hybrid license, the license should expressly and realistically allocate royalties between the patent right and the other rights. If the license provides for the use of a number of patents or different IPR, then it should provide for a reduction in royalties upon the expiration of one of the patents or other rights.

A **best efforts clause** is vital in an exclusive license agreement, since the licensor depends on the licensee to generate sales and royalty payments. Courts have implied such clauses in exclusive licenses, but the licensor would be better served by negotiating a specific best efforts clause with appropriate timetables, benchmarks for production and sales, the amount of monies to be expended by the licensee, and minimum royalty levels. The best efforts clause should provide “penalties” for failure to reach stated goals and for the termination of the license. The court in *Shearing v. Iolab Corp.*¹¹ extended the implication of best efforts to “improvements.” It held that it is customary in an exclusive licensing arrangement to imply an obligation of the licensee to use its best efforts with respect to improvements on the invention for which the licensee purchased rights.

Another purpose of the best efforts clause is to prevent a foreign country from issuing a compulsory license on the licensor’s technology to a third party. Some countries require a patent owner to use the patent in order to avoid losing the exclusive rights to exploit that patent in the country. Granting a license to a national of that country usually satisfies these so-called “working requirements.” The threat remains, however, if the licensee fails to work the license; in that case compulsory licenses may be granted to third parties. A best efforts clause should therefore require that the licensee “work” the license.

Transparency in the licensing relationship should be provided for in the license agreement. This is done through the insertion of accounting and record-keeping requirements. The accounting provision should call for periodic statements of sales and the royalty payments. It should also provide for some form of certification and audit of the sales amount and royalties owing. The licensor should require that an independent accounting firm perform an audit. The licensor should specify payment of interest on delinquent payments and assurances in case of default. The licensee should be required to retain records pertaining to the license and the sales of the licensed products.

Indemnification clauses work both ways between the licensor and the licensee. The licensee generally wants to be indemnified for any liability stemming from the licensor’s title or product warranties. The licensor seeks to be indemnified for any misuse of the license by the licensee.

The licensor should also protect itself through a **disclaimer** or limitation of warranty applicable against the ultimate purchaser or consumer. The licensor will want to insert language requiring the licensee to obtain customer signatures agreeing to the disclaimer or limitation.

A good technique used in conjunction with the indemnification clause is to require the licensee to obtain a product liability insurance policy. The best way to prevent liability for product defects is to require the implementation of quality control measures in the production process. The licensor will want to ensure that the licensee complies with quality standards and specifications. It should require that all product modifications require its prior approval. The licensor should also negotiate inspection rights and access to the licensee’s testing records and reports.

Warranties and representations made in the license are important in liability claims for negligence, misrepresentation, or breach of warranty. The licensor should insert language specifying that only express warranties are enforceable. To further prevent the implication of warranties, the licensor should insert pertinent **negations**. An example of negation includes the statement that the license does not grant the licensee the rights to any subsequent know-how or to additional technical support or information. Another negation may preclude the licensee from using the licensor's trade name. The problem with negation clauses is that a licensor with a U.S. patent cannot be assured that the negation clause will be enforced under foreign law.

The licensee should be required to take all reasonable measures to protect the licensor's copyrights and trademarks. The licensee's duties in this area should be detailed in an **infringement clause**. These duties include affixing the appropriate marks and patent numbers to the products being licensed. Failure to affix the patent numbers may prevent the licensor from collecting damages for past infringements.¹² The court in *Yarway Corp. v. Eur-Control USA, Inc.*,¹³ held that a licensor has a cause of action for damages resulting from the licensee's failure to mark goods as required under the license.

In the area of third-party infringement, the infringement clause places a number of obligations upon the licensee. First, the licensee should be made to act as the "eyes and ears" of the licensor since it is in the best position to uncover infringement. The licensee should be required to notify the licensor promptly of acts of infringement by third parties. Second, the licensee's cooperation in any infringement proceeding should be required under the transfer agreement.

The license agreement should also detail the rights and duties of the respective parties in the event that a third party sues the licensee for infringement. The most licensee-friendly provision would be an express covenant requiring the licensor to defend and indemnify the licensee against such claims. A licensor-friendly provision, on the other hand, would exclude or limit the licensor's obligations regarding such infringement claims.

One compromise would be to grant the licensee the right to indemnification but limit the indemnity. The licensor can limit its exposure by declaring the option to pay a specified amount to the licensee and terminate the license instead of defending the licensee against an infringement claim. In *Hewlett-Packard Co. v. Bausch & Lomb Inc.*,¹⁴ the court upheld such limited indemnification. Another compromise would be an agreement to share the costs of defending any third-party infringement claims.¹⁵

From the licensee's perspective, obtaining the right in the license agreement to sue third parties for patent infringement pertaining to the licensed property is not sufficient to actually sue under U.S. patent law. The licensor-patentee must be joined to any such infringement suit.¹⁶ U.S. patent law authorizes infringement actions only by the patentee-licensor¹⁷ or the assignee of a patent.¹⁸ The rationale for this rule is that a license grants to the licensee merely a privilege that protects him from a claim of infringement by the owner. As such, he has no property interest in the patent. "Hence the patent owner may tolerate infringers, and in such a case no right of the patent licensee is violated."¹⁹

The U.S. Supreme Court has long recognized that the patent owner is an indispensable party to an infringement suit.²⁰ The courts have also held that granting the licensee the right to sue for third-party infringement does not imply any obligation on the part of the licensor to assist in such actions. "There is no implied agreement by a licensor to protect the licensee by suing. In the absence of a covenant to protect the licensee against infringers there is no obligation on the part of the licensor to do so."²¹ Courts have, however, recognized the right of an exclusive licensee to join the licensor as an involuntary plaintiff to an infringement action.²²

In order to best protect its interests, the licensee should negotiate a clause requiring the licensor to either sue third-party infringers or to join the licensee in any such actions. The clause should state the repercussions for the licensor's failing to fulfill its obligations under the clause. For example, it may authorize the licensee to sue on behalf of the licensor and require the licensor to reimburse the licensee for the costs of the litigation or cease demanding royalty payments. The *Abbott Laboratories v. Diamedix Corp.* case that follows reviews the law regarding whether a licensee has *standing to sue* for the infringement of IPR included in its license.

Abbott Laboratories v. Diamedix Corp.*47 F.3d 1128 (Fed. Cir. 1995)*

Bryson, Circuit Judge. Diamedix Corporation appeals from an order denying its motion to intervene in a patent infringement action. This action was brought by Abbott Laboratories, which held a license from Diamedix, against Ortho Diagnostic Systems, Inc. We conclude that the district court should have permitted Diamedix to join the lawsuit as a party-plaintiff.

In exchange for annual royalty payments, Abbott received a worldwide license to make, use, and sell products incorporating the inventions claimed in the patents. The license was exclusive to Abbott and its affiliates, but was subject to the rights previously granted to Diamedix's other licensees. The agreement was to remain in effect for the life of the patents unless Abbott decided to terminate it earlier. The agreement was not assignable by either party without the consent of the other.

In addition to those general terms, the agreement contained a clause addressing the rights of the parties in suits against third parties for infringement of the patent rights. That clause provided as follows: "If any patent included in PATENT RIGHTS is infringed, Abbott shall have the right, but not the obligation, to bring suit to suppress such infringement against any unlicensed third party."

Abbott filed an action charging appellee Ortho Diagnostic Systems, Inc., with infringing the patents. Ortho denied the allegations of infringement, asserted as an affirmative defense that the patents are invalid, and claimed that Abbott is barred from seeking relief because of its delay in bringing suit. Because Abbott did not join Diamedix as a party to the lawsuit, Diamedix promptly filed a motion to intervene as a plaintiff-intervenor alleging that Ortho had infringed its rights under the two patents. Diamedix argued that Abbott has an incentive not to defend the validity of the patents with great vigor, since a decision invalidating the patents would free Abbott from its royalty obligations.

The Patent Act of 1952 provides that a civil action for infringement may be brought only by "a patentee." The statute defines "patentee" to include the party to whom the

patent was issued and the successors in title to the patent, and has been interpreted to require that a suit for infringement ordinarily be brought by a party holding legal title to the patent. Any less complete transfer of rights is a license rather than an assignment. If the patent owner grants only a license, the title remains in the owner of the patent; and suit must be brought in his name, and never in the name of the licensee alone.

The Supreme Court recognized an exception to that rule for cases in which the owner of a patent refuses or is unable to be joined as a co-plaintiff with the exclusive licensee in an infringement action. The Court emphasized, however, that before the exclusive licensee can sue in the patent owner's name, the patent owner must be given an opportunity to join the infringement action. Diamedix retained substantial interests under the patents. Abbott, therefore, does not have an independent right to sue for infringement as a "patentee" under the patent statute. Diamedix retained the right to make and use, for its own benefit, products embodying the inventions claimed in the patents, as well as the right to sell such products to end users, to parties with whom Diamedix had preexisting contracts, and to preexisting licensees.

In light of the various rights that Diamedix retains under the agreement, Abbott must be considered a licensee, not an assignee. The district court's decision denying Diamedix's motion to intervene is REVERSED.

Case Highlights

- The invalidity of a patent is an affirmative defense against a claim of patent infringement.
- An assignment of the entire patent, unlike a license of the patent, makes the assignee the owner and gives it standing to sue against third-party infringement.
- An exception to the rule that a licensee does not have independent standing to sue a third-party infringer is made for an exclusive licensee, as long as the patent owner is given an opportunity to join the infringement action.

Validity or no-challenge clauses prohibit the licensee from challenging the exclusiveness or validity of the licensor's IPR. Such clauses are generally valid in the U.S.,²³ but may be invalid in some foreign countries, where they are considered illegal restrictive trade practices. They are also often prohibited in the transfer-of-technology codes found in developing countries.

The license agreement should define the licensee's rights to assign or sublicense its license rights through the insertion of **assignment** and **sublicensing clauses**. The licensor will generally require that the license cannot be sublicensed or assigned.

The **non-partnership and independent contractor clause** makes clear that the licensee is not acting as an agent or partner of the licensor, hopefully preventing the licensor from being held liable for the actions of the licensee under agency law principles.

Specific termination rights are detailed in a **termination clause**. The termination clause provides the specific grounds upon which the licensor may unilaterally terminate the license agreement. The licensor should make it clear that the termination of the license also requires the termination by the licensee of any sublicenses. Under some foreign laws the unilateral termination of a licensing agreement by the licensor may require the payment of an indemnity. For this reason, the licensor should specify the types of causes that can automatically trigger a termination without indemnity. For example, the failure of the licensee to meet prescribed sales quotas could result in an automatic termination of the license.

The *Paramount Pictures Corp. v. Metro Program Network, Inc.* case examines a typical termination clause and the remedies available to the licensor against a licensee that violates the default provisions of the clause. The case also examines post-termination use by the licensee.

All licenses, especially international ones, should provide for dispute resolution. This is done through choice of law and forum selection provisions. Given the unevenness of foreign intellectual property law protections, a U.S. licensor should designate U.S. intellectual property law as the law of any dispute. However, a host country court is unlikely to honor a choice of law that avoids its competition, intellectual property transfer, consumer protection, and termination laws.

Paramount Pictures Corp. v. Metro Program Network, Inc.

962 F.2d 775 (8th Cir. 1992)

Magill, Circuit Judge. Metro operates commercial television station KOCR-TV in Cedar Rapids, Iowa. Fitzgerald is the president, general manager, secretary, registered agent, and sole shareholder of Metro. During January 1988, Fitzgerald signed eight interim license agreements with Paramount to broadcast episodes of *Happy Days*, *Mork and Mindy*, and *Taxi*, and packages of motion pictures. Paramount accepted Metro's offers to license these products by letters dated January 28 and March 1.

Under the interim agreements, Metro was to pay Paramount 10 percent of the license fees on January 14, and the remainder in 36 equal monthly installments. Each of the agreements contained the following language: "The license arrangement is subject to those additional provisions as are contained in Paramount's Standard Series Contract and Paramount's Standard Terms and Conditions, copies of which are available on request, and will be fully set forth in a formal written contract." Fitzgerald tendered a check to Paramount dated January 14 in the amount of \$26,000. This check was dishonored on March 19 because Metro's account was closed. No other payment was made by Metro under the contracts. Prior to March 19, Paramount had delivered the episodes of *Happy Days*, *Mork and Mindy*, and *Taxi* to Metro and Metro began to broadcast them.

On May 6, having not received any payments under any of the contracts, Paramount sent Metro a letter terminating the contracts pursuant to the bankruptcy and default provision of the Standard Terms and Conditions and reserving their rights to collect the sums due under the contracts. The provision provides in pertinent part: "If Licensee shall default in the payment of any sums payable in accordance with the terms of this Agreement and such default shall continue for a period of ten (10) days, any and all installments or sums payable under this Agreement remaining unpaid shall immediately become due and payable to Paramount."

"In addition, Paramount shall have the right to (i) terminate each and all of the rights of Licensee under this Agreement and/or (ii) suspend the further delivery of prints until such defaults shall have ceased and shall have been remedied, and/or (iii) seize, wherever found, any print of any licensed picture delivered to Licensee hereunder." On May 20, Paramount sent a second letter, saying that it had been informed that Metro was broadcasting Paramount products "in direct contravention of the Notice of Termination of KOCR's telecast rights dated May 6, 1988," and that the unauthorized broadcast of those products constituted a willful infringement of Paramount's copyrights.

Appellants claim that the district court erred in granting appellees both breach of contract damages and copyright infringement damages because this constitutes an impermissible award of double damages. Under the Copyright Act of 1976, the copyright owner suing an infringer is entitled to either actual damages under §504(b) or statutory damages under §504(c).

Section 504 reads, in pertinent part:

- a In General. Except as otherwise provided by this title, an infringer of copyright is liable for either—
 - 1 The copyright owner’s actual damages and any additional profits of the infringer, as provided by subsection (b); or
 - 2 Statutory damages, as provided by subsection (c).
- b Actual Damages and Profits. The copyright owner is entitled to recover the actual damages suffered by him or her as a result of the infringement, and any profits of the infringer that are attributable to the infringement and are not taken into account in computing the actual damages.
- c Statutory Damages. The copyright owner may elect, at any time before final judgment is rendered, to recover, instead of actual damages and profits, an award of statutory damages for all infringements involved in the action, with respect to any one work in a sum of not less than \$250 or more than \$10,000 as the court considers just.

The district court found that appellants had broadcast 47 episodes of the three sitcoms owned by Paramount after May 20. The court awarded them \$500 per infringement, totaling \$23,500 in statutory copyright infringement damages. Appellants claim that the breach of contract damages are really an award of actual damages under §504(b) because the

claimed infringements occurred during the time the licenses would have been in effect if they had not been terminated and, therefore, appellees are not entitled to both awards.

We find that the breach of contract damages award is not an award of actual damages for copyright infringement under §504(b). The breach of contract claim asserted by Paramount relates solely to events that occurred before May 6. The district court recognized this, and relied strictly on contract law and on the events that took place before May 6 in analyzing this claim. Because appellants did not pay Paramount any of the money owed under the license agreements, they were in default, or breach, of the contracts. Appellants were liable for these damages even if they had not broadcast any Paramount products after the contracts were terminated. In contrast, the copyright infringement claim relates to events that occurred after May 6. Once Paramount exercised its contractual right to terminate the licenses on May 6, appellants no longer had any right to broadcast Paramount products.

Because the damage awards for breach of contract and copyright infringement were for completely separate injuries, the district court correctly awarded both breach of contract damages and copyright infringement damages to appellees. **AFFIRMED.**

Case Highlights

- A well-worded termination clause allows the licensor to quickly cancel the licensee’s rights.
- A licensee who continues to use licensed property following the termination of its license is susceptible to different claims for damages: (1) actual damages for breach of contract and (2) statutory damages for infringement.

The most common forum selection clause in international licensing agreements is the arbitration clause. To enhance one’s ability to obtain and enforce a foreign arbitral award, the place of arbitration should be in a country that has ratified the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (“New York Convention”) and where the courts do not have a reputation for interfering with arbitration proceedings.

Law of Licensing

In the event that a licensing agreement fails to resolve a disputed issue, what body of law will be used to interpret and enforce the contract? If a court determines that a license is essentially a sale of goods, then the Uniform Commercial Code (UCC) or the Convention on Contracts for the International Sale of Goods (CISG) would apply.

This has generally been the case involving the sale of software or licensing of some information products. But, for more complicated licensing contracts, the common law of contracts would apply in the U.S.

Some transactions have a mix of subject matter, such as sale of goods, sale of services, and licensing of IPR. The issue becomes which law should be applied to such a contract? The **mixed sale** articles of the UCC and CISG indicate that software sale contracts are to be considered sales of goods unless a “preponderant part of the obligations consists of labor or services” or the purchaser supplies “a substantial part of the materials.” Under the UCC, “off the shelf” software has been determined to be a good. One view of the licensing of information sees the license as a “sale” of the exclusive rights to use that particular copy of the information. But again, in most cases, IPR and information licensing would fall outside the concept of a “sale of goods” because the licensor retains title to the IPR and the proprietary information. The next section will briefly review a model law dealing specifically with some types of licensing contracts.

Uniform Computer Information Transactions Act

A series of rules that may be applied to licensing transactions are found in the **Uniform Computer Information Transactions Act (UCITA)**. A brief review of its provisions is useful for two reasons. First, UCITA highlights some of the issues that confront licensors of IPR, technology, and information. Second, its provisions can be used in the negotiation and writing of a license agreement. The UCITA is a model law for regulating the formation, performance, and enforcement of computer information transactions. *Computer information transactions* are defined as agreements “to create, modify, transfer, or license informational rights.”

UCITA expressly states that a license of such rights is not a good for purposes of Article 2 of the UCC. In UCITA, information is defined as “data, text, images, sounds, or computer programs, including collections and compilations.” License means “a contract that authorizes access to, or use, distribution, performance, modification, or reproduction of information including, access contracts, lease of a computer program, and a consignment of a copy.” UCITA provides rules to deal with legal issues pertaining to contract formation, authentication, duties and rights of performance, breach, remedies, and warranties.

Formation of a License Contract

The formation or offer-acceptance rules in UCITA mimic those found in Article 2 of the UCC, with some noticeable variations. The dispatch or *mailbox rule* is modified for electronic acceptance. Under UCITA, an electronic acceptance is effective upon receipt. Another model law, the **Uniform Electronic Transactions Act (UETA)** states that the acceptance is received when it enters the e-mailbox. Section 15 (b) of UETA states that “an electronic record is received when it enters an information processing system that the recipient has designated for the purpose of receiving electronic records or information.” The obtaining and giving of an e-mail address satisfies the designation requirement.

The next issue raised by UCITA is whether a license can be formed between computers or between a human and a computer. UCITA answers in the affirmative on both questions. It defines **electronic agent** as “a computer program, or electronic or other automated means, used by a person to initiate an action, or to respond to electronic messages or performances, on the person’s behalf without review or action by an individual.” Therefore, placing an order through a web page or voice mail creates a contract. Is an offeree able to make a counteroffer when dealing with an electronic agent? No, because electronic agents are unable to evaluate and respond to counteroffers or to acceptances with additional terms. The counteroffer will be construed as an acceptance if it causes the electronic agent to perform, provide benefits, or allow the use or access that is the subject of the counteroffer.

UCITA also addresses a number of issues pertaining to the writing requirements of the **Statute of Frauds**. First, UCITA sets a licensing fee or price amount of \$5,000 before a writing is required. In contrast, Article 2 of the UCC requires a writing for all sale of goods valued at \$500 or more. Second, it expands the Statute of Fraud’s notion of a “writing” and “signature” to include **electronic records** and **authentication**. An electronic record is information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in

perceivable form. To “authenticate” or sign an electronic record is to execute or adopt an electronic symbol, sound message, or process referring to, attached to, included in, or logically associated or linked with that record. One method of proving an authentication is through an attribution procedure. This usually entails the use of algorithms or other codes, identifying words or number, encryption, or callback, or other acknowledgment.

Foreign Transfer Restrictions

The EU Regulations discussed below, although restrictive, offer the importer of technology or the licensor of intellectual property a degree of harmonization throughout the EU. The People’s Republic of China’s regulations on the importation of technology will also be examined.

European Union Regulations

In Europe, a foreign licensor must understand the restrictions posed by the competition laws of the EU and of the individual countries. Many European countries have strict antitrust laws that affect technology and IPR licensing. In some countries, such as Italy, competition law is relatively new²⁴ and is a close adoption of EU legislation. The EU Regulations control the legality and scope of clauses dealing with parallel or gray market imports, infringement, tying clauses, royalties, and term or duration of the license. The EU’s block exemption regulation—Commission Regulation (EC) No. 772/2004 of April 27, 2004, dealing with the application of article 81(3) of the Treaty of Rome to categories of technology transfer agreements—governs patent and information licensing agreements, as well as design and model rights and software copyright licenses.

EU competition law incorporates the following restrictions: First, a licensing clause cannot prohibit gray market or parallel importing of goods legally produced, it can however prohibit a licensee from using the license outside the licensed territory, or more specifically, in the territory of the licensor. Second, no-challenge or **validity clauses** are void by law. A licensee cannot be prohibited from challenging the validity of the licensor’s right to the intellectual property that is the subject of the license.

Third, a **tying clause** often requires that a licensee purchases its supplies of unlicensed materials from the licensor or a designated supplier. This requirement is allowed only if the licensor justifies the tying to issues of quality control or regularity of supply. Although many jurisdictions have no express requirements regarding quality control provisions in a trademark license agreement, such license agreements in the U.S. must include quality control rights to the licensor for the license grant to be valid. Otherwise, it is considered as an invalid “naked” license. In such a situation, both licensee and licensor lose their rights to prevent unauthorized use of the trademark. Patent owner–licensors often attempt to “tie” the license grant for a patented invention to use of tangential or related items—though not covered by the patent—that also inure to the benefit of the licensor. Licensors also may try to “tie” negative obligations, namely requirements to refrain from making or selling items related to the invention. As with patent pools, tying is not necessarily anti-competitive or impermissible; the legality of such arrangements often depends upon the parties’ relative market power. In some jurisdictions, negative tying is prohibited outright, regardless of market power.

Fourth, the license can require the payment of a minimum royalty amount regardless of actual sales, but it cannot require payment of royalties for rights or know-how that subsequently become unprotected or become public information. Fifth, the term of the license may not extend beyond the expiration of the latest patent or intellectual property right.

In general, a licensor may grant exclusive territories, but is prohibited from limiting competition. It may prohibit its licensees from soliciting sales from outside their exclusive territories, but cannot prohibit unsolicited or passive sales. Gray market sales or parallel imports are therefore permitted under EU law. This prohibition against limiting competition prevents a licensor from compartmentalizing territories and artificially setting different prices based on the market conditions in a particular country. EU competition law also prevents the licensor from limiting the licensee to purchasing from a certain supplier. Therefore, nothing prevents one licensee from purchasing licensed products from another licensee.

EU law on gray market sales prevents the licensor from completely prohibiting sales or movement of licensed products outside the licensee's exclusive territory. For example, a licensee or distributor cannot be prohibited under EU competition law from filling unsolicited orders coming from outside its territory. A clause may, however, prohibit the licensee from selling the products of a competitor of the licensor. Despite the fact that exclusivity is a natural characteristic of most licensing, franchising, and distribution agreements, some foreign courts imply that an agreement is nonexclusive if it does not expressly state that it is an exclusive grant of rights.

Exclusive licenses of patents or know-how where the licensor agrees not to work the licensed territory are now expressly exempted from EU competition law. However, the duration of such licenses is limited. An exclusive patent license may extend for a period equivalent to the parallel license of the licensee. A **parallel license** is defined as the period that such patents would be granted under the national laws of the licensee. Know-how licensing agreements are limited to a period of 10 years from the time that a licensee markets the product.

The EU law expressly allows the following clauses (*white-listed clauses*): (1) confidentiality provisions prohibiting the licensee from disclosing licensor's know-how; (2) prohibition of the continued use of the licensor's technology after the expiration or termination of the license; (3) nonexclusive grant-back clauses; however, the licensor may be required to grant an exclusive license to the licensee for subsequent improvements made by the licensor; (4) best efforts clauses requiring the licensee to fully work the technology in the licensed territory; (5) clauses giving licensor the right to terminate the license in the event that the licensee challenges the validity of the licensor's patents; (6) field-of-use restrictions; (7) production limitations when the licensed product is a component part of another product; and (8) obligations to pay royalties on sales of nonlicensed products (momentum royalties), a practice which was formerly unenforceable and is now permitted.²⁵

EU Regulation 240/96 impacts other types of contracts. For example, joint ventures between competitors involving technology transfers may benefit from the new regulations. However, to benefit from the block exemption provided by the Regulation, the parent companies of the joint venture may not have a combined market share of more than 20 percent in a production joint venture or 10 percent in a distribution joint venture.

Another extension of the Regulation is in the area of software licensing. Software licensing agreements based on copyright are protected under by the Regulation if patents or know-how accompanies the software. Thus, the lists of exempted and prohibited contract clauses are applicable to most types of technology transfer agreements.

Regulations of the People's Republic of China

China's regulations regarding the importation and licensing of technology have been liberalized over the years. At one time, the strictness and complexity of China's licensing regulations posed a serious obstacle to foreign licensors. The licensing agreement needed to be approved by numerous government agencies. For example, approvals often need to be obtained from a national ministry, provincial government, and the local municipality. More disturbingly, the IPR Transfer Regulations imposed numerous prohibitions on the substantive content of the licensing transfer. Numerous contract provisions were held to be invalid, such as pro-licensor grant-back clauses and restrictions on post-termination use of the technology. In 1999, China's Technology Contract Law and Foreign Contract Law were repealed and replaced by a uniform Chinese Contract Law (see Chapter 9). The 1999 Chinese Contract Law has provisions for technology contracts. The provisions are divided into four parts: (1) General Rules, (2) Contracts for Technological Development, (3) Contracts for the Transfer of Technology, and (4) Contracts for Technical Consultancy and Contracts for Technical Service. See Figure 19.5 *Comparative Law*: "Excerpts from Chinese Contract Law."

Despite the removal of the more intrusive regulations of foreign licensing contract under Chinese law, the excerpts show some of the influences of the old, government approval laws. Article 326, although recognizing that ownership of a work vests in the organization in a work for hire contract and not the creator or author of a work, it states that the owner has an obligation to "compensate the individual who completed the work made for hire." In addition, the creator of the work is given preemptive rights in cases where the owner seeks to transfer total ownership of the work.

Article 326: Work for Hire

Where the rights to use and transfer a work made for hire vest in a legal person or another organization, the legal person or other organization may conclude technology contracts in respect of the work made for hire. The legal person or other organization shall allocate a certain percentage of the benefits derived from the use or transfer of the work made for hire as a reward or remuneration to the individual who completed the work made for hire. If the legal person or other organization concludes a technology contract to transfer the work made for hire, the individual who completed the work made for hire has the preemptive right to be transferred the work on the same conditions.

Article 346: Confidentiality

The licensee under a contract for the licensing of patent shall exploit the patent in accordance with the agreement and shall not

allow any third person other than those covered in the agreement to exploit the patent.

Article 349: Licensor Warranty

The transferor under a contract for the transfer of technology shall warrant that he is the lawful owner of the technology provided by him and that the technology provided by him is complete, error-free, effective and capable of achieving the agreed purpose.

Article 354: Ownership of Improvements

The parties may, in accordance with the principle of mutual benefit, agree in a contract for the transfer of technology on the method of sharing the technological achievements that result from follow-up improvements on the exploitation of the patent or the use of the technological secret. If there is no such agreement, the other party is not entitled to share the technological achievements made by one of the parties in the follow-up improvements.

Figure 19.5 Comparative Law: Excerpts from Chinese Contract Law.

Article 346 implies a duty of confidentiality on all licensees. Article 349 states that a licensor warrants its ownership of the licensed technology, as well as providing an implied warranty of quality that its technology is “complete, error-free, effective and capable of achieving the agreed purpose.” There is no indication that these implied warranties are disclaimable in any way. Finally, Article 354 relates to the important issue of ownership and rights to use improvements made by the licensee. It allows the parties to allocate the rights to such improvements (grant-back clause), but provides a default rule that if they fail to do so, full ownership in the improvements vest in the licensee.

Chapter Summary

- 1 The licensing of intellectual property rights (IPR) and technology has become a substantial part of the world economy. Licensing contracts provide the licensor with the opportunity to include clauses to protect the IPR it is licensing. IPR licensing is subject to numerous laws, such as home country laws (law of licensor) that are applied extraterritorially; international IPR conventions; foreign host country’s laws that provide protection; and host country laws that regulate the content of the licensing agreement.
- 2 Under U.S. law, Section 337 of the Tariff Act of 1930, an IPR owner may petition the U.S. International Trade Commission (ITC) for the issuance of cease and desist orders preventing infringing foreign goods from being imported into the U.S. However, this remedy is generally reserved for the importation of counterfeit goods and not for goods produced under a license.
- 3 The gray market is one of the major risks of licensing IPR for the production of goods in other countries. Some of these countries have lower costs of production, which leads to the temptation to export licensed goods to higher priced markets including the markets of the licensor and other licensees. It is crucial that the license contract combat the exportation of goods through territorial restrictions, maximum quantities of production, and maximum sales to individual purchasers. However, under some laws, such as EU competition, these provisions may be invalid.
- 4 The most important clause in a license is the grant clause, which states the IPR rights, trade secrets, and know-how that are being licensed. The license may be exclusive or nonexclusive and include other restrictions, such as field of use. The grant-back clause deals with the ownership and right to use any improvements made by the licensee.
- 5 Any exporter (licensor) of IPR should make sure it follows all necessary formalities, such as the registration of licenses in pertinent countries, as well as inserting clear duration and territorial provisions in its license so that ones will not be implied later by a court.

- 6 Common licensing clauses include reservation of rights, royalties, best efforts, quality control, confidentiality, most-favored licensee, infringement, and termination clauses.
- 7 In the U.S., the applicable law for licensing contracts is the common law of contracts. Other countries like China have specific rules that relate to licensing and technology contracts. The European Union has strict regulations invalidating some pro-licensor clauses that violate EU competition law.
- 8 The Uniform Computer Information Transactions Act (UCITA) is a nonbinding model law that provides useful rules that can be applied to some licensing contracts.

Key Terms

Antitrust Enforcement Guidelines for International Operations	Guaranteed Consideration	Registration
Assignment Clause	Hybrid License	Representations
Authentication	Indemnification Clause	Reservation of Rights Clause
Best Efforts Clause	Independent Contractor Clause	Royalties
Brand Protection Units	Inducement to Infringe	Royalty Clause
Choice of Law Clause	Infringement Clause	Statute of Frauds
Confidentiality Clause	International Trade Commission (ITC)	Sublicensing Clause
Covenant Not-to-Compete	Key Personnel	Tariff Act of 1930
Cross-Licensing	Licensed Territory Clause	Technology Transfer
Disclaimer	Licensee	Technology Transfer Laws
Due Diligence	Licensor	Termination Clause
Duration Clause	Mixed Sale	Trade Names
Electronic Agent	Momentum Royalties	Tying Clause
Electronic Records	Most-Favored License Clause	U.S. Copyright Act
Exclusive License	Negations	Uniform Computer Information Transactions Act (UCITA)
Field of Use	Non-partnership Clause	Uniform Electronic Transactions Act (UETA)
Forum Selection Clause	Opinion Letter	Validity Clause
Grant Clause	Parallel License	Warranties
Grant-Back Clause	Patent Pools	
Gray Market	Recitals	

Chapter Problems

- 1 McCoy hired Mitsuboshi to make and supply shrimp knives covered by McCoy's patent and trademarks. When Mitsuboshi produced the knives, McCoy refused to pay for them. Mitsuboshi resold the knives to Admiral Craft. McCoy sued Mitsuboshi Cutlery, Inc. for patent and trademark infringement in violation of U.S. federal law. Is Mitsuboshi guilty of patent and trademark infringement? *McCoy v. Mitsuboshi Cutlery, Inc.*, 67 F.3d 917 (Fed. Cir. 1995).
- 2 "Green River" is the trademark under which Sethness-Greenleaf, Inc., sold to bottlers a soft drink according to a formula that was Sethness-Greenleaf's trade secret. Sethness-Greenleaf sold the Green River business, including the trademark and the trade secret, to Green River Corp. The purchase price was to be paid in installments. When the price was paid in full, the secret formula for the manufacture of Green River beverage and syrup, till then held in escrow, would be released to Green River Corp. Green River Corp. fell behind in its payments and Sethness-Greenleaf declared a default, stopped supplying Green River Corp., and demanded the return of the formula from the escrow agent. Unwilling to stop doing business under the "Green River" name, Green River Corp. procured a green soft drink from another producer and sold it under the

- “Green River” name, precipitating this suit by Sethness-Greenleaf. Green River Corp. counter-claimed that it is not guilty of infringement because Sethness-Greenleaf’s failure to continue to supply it with the product was a breach of contract. Assuming that Sethness-Greenleaf is guilty of breach, is Green River Corp. correct? *Green River Bottling Co. v. Green River Corp.*, 997 F.2d 359 (7th Cir. 1993).
- 3 Your company produces a quality component product that is used in the manufacture of high-scale stereo equipment. The component is manufactured through the use of special software developed by your company. The component and associated software are covered under a number of U.S. patents and copyrights. In addition, your company holds a federally registered trademark that stereo manufacturers are allowed to use in the marketing of their products. Your company has made it a strategic goal to expand the production and sale of the components overseas. It is considering licensing the technology in exchange for royalties; however, it wants to protect the market of its domestic manufacturers. What steps should be taken to maximize protection of the company’s intellectual property rights? What license terms should your company insist upon?
 - 4 The premier German manufacturer of compact discs decides to export its discs to markets in Eastern Europe. Because of the economic realities of these emerging-economy countries, the manufacturer is forced to sell the discs at a lower price than it sells them in the German market in order to obtain market share. A wily entrepreneur purchases large quantities of the exported discs and reimports them into the higher priced German market. What is the likely result under European Union law of the German manufacturer’s attempt to prevent the importation of the discs?
 - 5 Your company, a technology company based in the United States, holds a number of patents on Internet-related business applications. It is negotiating a licensing agreement with a major French innovator of Internet technologies. Your company’s standard grant-back clause provides a non-reciprocal reversion of all licensee improvements. The French company is refusing to execute the agreement because of the one-sided nature of the clause. Your job is to draft a fair grant-back clause that provides reciprocal rights to the licensor and licensee. How should such a clause deal with the questions of ownership and use? What will be the status of these rights after the termination of the license?
 - 6 License Writing and Review Problem: You represent an American manufacturing company whose products are based upon an assortment of patents, copyrights, trademarks, trade secrets, and know-how. The company has a very popular line of electronic products that has only been marketed and sold in the U.S. and Canada. The company is considering licensing the rights to produce the products to companies in other markets. Your company has been approached by a manufacturer-distributor from Nigeria who wants to negotiate a contract for the central African market. The Nigerian company had entered into such licensing agreements before and provided a “prototype” license agreement. Your company’s major concerns include: How will it be able to control the quality of the products being manufactured by the licensees and the impact of the relevant host country laws, including laws relating to intellectual property rights, competition (antitrust), currency control, and taxation? Your job is to review the license and determine if the clauses adequately protect your company’s interests. How would you make the relevant clauses more pro-licensor? Additional questions are given at the end of the Licensing Agreement.

Licensing Agreement

Licensing agreement between “American Tech Products Company” (licensor-patentee) and Nigerian Manufacturing Limited (licensee). The Parties hereby agree to enter the following Agreement:

Operative Clauses

1. License Grant

Licensor hereby grants to the licensee an exclusive, nontransferable license and right to manufacture and sell the product within the countries of Nigeria under

the licensor's trademark, along with the rights to use related patents, information, and know-how that will be provided by the licensor. The licensor will provide all necessary data, specifications, technology, and marketing information relating to the product and its manufacture.

2. Future Improvements (Product and Process)

During the duration of this license, the licensee shall supply to the licensor any improvements and know-how to the process of manufacture (process) or product developed subsequently to the signing of this agreement at no additional costs (royalty).

3. Grant Back

The licensee shall promptly notify the licensor of any improvements it has made or developed relating to the product or process. The licensee will provide a cross-license to the licensor to use the improvement without paying royalties. The licensee shall have the right to patent the improvement.

4. Confidentiality

License shall treat all information and rights provided by licensor as "secret and confidential," except to the extent that the information becomes part of the public domain. License shall divulge the information to only key personnel and to third parties on a need to know basis.

5. Support

If the licensee requires additional assistance the licensor shall use its best efforts to comply with the requests for assistance. The licensee shall pay additional remuneration for the additional services.

6. Royalty

The licensee shall pay a six percent (6%) royalty fee to the licensor on licensee's net sales. Any income tax on the licensor's royalties claimed by the host countries listed in Clause 1 shall be paid by the licensee and deducted from the royalty due the licensor.

7. Reports

Accrued royalties shall be due no later than 45 days after the end of each quarter. Each payment shall be

accompanied by a report that includes an itemized list of products sold and at what prices. The licensee's senior accountant and Chief Financial Officer shall certify each report.

8. Payment

The royalty payment shall be in U.S. dollars at the conversion rate posted on the date of remittance. The costs of conversion shall be to the account of the licensor.

9. Audit

Licensee shall maintain accurate records of all sales, which shall annually be audited and certified by licensee's auditor. The cost of the audit and certification shall be paid by licensor.

10. Patent and Trademark Protection

Licensor shall take all action needed to maintain its patents and trademarks in the host countries including renewing all necessary registrations. Licensee shall display licensor's trademarks at all times to make clear to all third parties of licensor's ownership and in order to prevent the trademark from becoming generic.

11. Third-Party Patent Claims

Licensor warrants that it has clear title and ownership to all intellectual property rights being licensed and that their use will not infringe on any third-party rights. Licensor shall defend and "hold harmless" against any third-party claims against license for infringement.

12. Infringement of Licensor's Patents

Licensee shall promptly notify licensor of any infringements by third-parties on licensor's patent and trademarks. Licensor may, at his discretion, take legal steps to enforce its rights.

13. Duration and Expiration

The license shall continue in force until the expiration of the last patent related to the product or needed to produce the product unless the license is terminated "for cause" as provided in Clause 14 and Clause 15. Upon termination of the license, the licensee shall cease to manufacture and sell the licensed products, as well as the licensor's trademark. Licensee shall maintain the confidentiality of licensor's information

and know-how unless they become a part of the public domain.

14. Cause and Notice

The licensor may terminate this license by giving three months written notice for the following reasons:

- a If licensee fails to begin production within four months of receiving all necessary information from the licensor;
- b If licensee fails to start marketing and sales of the product within three months of the production of the products;
- c If licensee fails to pay royalties within twelve months of the time provided under Clause 8 unless the delay is due to a *force majeure* event;
- d If licensee sells or transfers a controlling interest in its company, becomes insolvent, or files for bankruptcy.

15. Momentum Clause

In consideration for the marketing value of licensor's product and its likely positive impact on other products sold by the licensee, licensee shall pay a 2% royalty on net sales of any increases in the sale of the other products for the period of this license.

16. Applicable Law

The Law of the State of New York shall govern this contract, and any claims or disputes related to it.

17. Arbitration

In the event of a dispute over a breach of this contract or any related claims, the dispute shall be submitted for arbitration. The arbitration panel shall consist of three arbitrators, each party shall nominate one arbitrator. The two arbitrators shall select the third arbitrator. The arbitration proceeding shall be conducted under the Arbitration Rules of the International Chamber of Commerce.

Questions:

- 1 Which clauses are one-sidedly pro-licensee?
- 2 How would you change the clauses to be more pro-licensor?
- 3 What terms are ambiguous? What words should be defined in the agreement?
- 4 What terms are missing? Are there terms missing that would better protect the interests of the licensor?
- 5 What "generic terms" are missing? How would you make the contract more comprehensive?

Internet Exercises

- 1 Review the web site of The Cyberspace Law Institute for information on how the Internet inter-relates with intellectual property law: <http://www.cli.org>.
- 2 Review the web site of the U.S. Copyright Office to determine the requirements for registering a copyright license: <http://www.lcweb.loc.gov>.
- 3 You own publishing rights to a catalog of popular "do-it-yourself" home and electronic repair

manuals. Distributors located in Germany, Italy, and India have approached you. What are your concerns regarding the licensing of the copyrights to these manuals? Develop a due diligence checklist to be used in the negotiation of these licenses. How would your checklist differ for the three countries?

Other Internet Sources

Text of **Section 337 of the Tariff Act of 1930**: <https://www.law.cornell.edu/uscode/text/19/1337> and https://www.usitc.gov/press_room/us337.htm.

"**Licensing Digital Information**" (Yale Library) provides examples of and commentary on a number of important licensing clauses: <http://www.library.yale.edu/~llicense/remcls.shtml>.

Text of **UCITA**: <http://www.ucitaonline.com>.

Notes

- 1 U.S. Commercial Service, *A Basic Guide to Exporting* (D. Barry ed., 11th ed. 2015).
- 2 For a brief review on issues in licensing and standard see Raymond T. Nimmer, “Issues in Licensing: An Introduction,” 42 *Houston Law Review* 941 (2005–06).
- 3 See generally, Mary Ann Tucker, “Checklist for Due Diligence in Intellectual Property Transactions,” 14-1 *Corporate Counsel’s Quarterly* 68 (1997).
- 4 Daniel Chow, “Anti-Counterfeiting Strategies of Multinational Companies in China,” 41 *Georgetown, Journal of International Law* 749 (2010).
- 5 Most-favored license clauses were held to be enforceable in *Carpenter Tech. Corp. v. Armco, Inc.*, 800 F.Supp. 215 (E.D. Pa. 1992).
- 6 35 U.S.C. §§100, 271 (a) (1994).
- 7 See *U.S. v. Radio Corp. of America*, 117 F. Supp. 449 (D. Del. 1954).
- 8 ICC, *The ICC Intellectual Property Roadmap* (12th ed. 2014).
- 9 See *Santa Fe Pomeroy, Inc. v. P. & Z. Co.*, 569 F.2d 1084 (9th Cir. 1978).
- 10 379 U.S. 29 (1964).
- 11 712 F. Supp. 1446, 1455 (D. Nev. 1989).
- 12 35 U.S.C. §287.
- 13 775 F.2d 268 (Fed. Cir. 1985).
- 14 909 F.2d 1464 (Fed. Cir. 1990).
- 15 See *Ortho Pharm. Corp. v. Genetics Institute, Inc.*, 52 F.3d 1026 (1995).
- 16 See *Yarway Corp. v. Eur-Control USA, Inc.*, 775 F.2d 268 (Fed. Cir. 1985).
- 17 35 U.S.C. §281.
- 18 U.S.C. §261 authorizes such actions by “assignees, grantees, and successors.”
- 19 *Western Electric Co. v. Pacent Reproducer Corp.*, 42 F.2d 116, 118 (2d Cir. 1930).
- 20 *Waterman v. Mackenzie*, 138 U.S. 252 (1891).
- 21 *Water Technologies Corp. v. Calco Ltd.*, 576 F.Supp. 767, 772 (N.D. Ill. 1983).
- 22 See *Rite-Hite Corp. v. Kelly*, 56 F.3d 1538 (Fed. Cir. 1995).
- 23 See *Bausch & Lomb, Inc. v. Barnes-Hind/Hydrocurve*, 796 F.2d 443 (Fed. Cir. 1986).
- 24 Italy enacted its first competition law in 1990 (Law Number 287 of October 10, 1990).
- 25 See Commission Regulations 556/89, Article 3(3) and 2349/84, Article 3(4).

Part VII

FOREIGN DIRECT INVESTMENT AND E-COMMERCE



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FOREIGN DIRECT INVESTMENT

The era of free trade in goods and services, beginning in the post–World War II era with the creation of the General Agreement on Tariffs and Trade (GATT), is also an era of the opening of capital markets and the free flow of investment funds throughout the world. The interconnectedness of the financial markets and the proliferation of **foreign direct investment (FDI)** shows that the world economies grow and falter due to economic shocks that can happen any place in the world.

FDI is the category of international investment made by a resident entity (direct investor) to acquire a lasting interest in an entity operating in another country other than that of the investor (**direct investment enterprise**). The World Bank defines FDI as the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. Net FDI is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital flows as reflected in a country's balance of payments. The opposite of FDI is **disinvestment** or the *outflow* of money by foreign investors. In 2013, the largest beneficiaries of FDI were China (\$348 billion), the United States (\$295 billion), and Brazil (\$81 billion). See Table 20.1 *Doing Business Internationally*: “Foreign Direct Investment: Net Inflows” for the amount of funds invested in various countries over a four-year period.

As the chart in Table 20.1 shows, the two countries that received the most inflow of FDI were China and the U.S. by a large margin, and China's amount does not include an additional \$77 billion FDI that flowed into Hong Kong. Other interesting points include the FDI inflow of two other BRIC countries: Brazil with \$81 billion and Russia with \$71 billion, while India, with a population exceeding 1.3 billion people, had a meager FDI inflow of \$28 billion.

Why is there so little FDI in India, given the potential size of its consumer market and its position as the world's largest stable democracy? One reason is that it has long had severe **equity participation requirements**, which have deterred foreign investment. These requirements limit the percentage ownership in a company that can be held by foreign interests. For example, at the time of the **Bhopal disaster** in 1984, the maximum equity ownership for foreign investors was only 51 percent and at other times the maximum was set at 49 percent. Union Carbide, an American company, was seen as the responsible party. But in fact by agreement with the Indian government it was not in direct control or management of Union Carbide India Limited, which was the owner of the Bhopal plant. The other major owners of the company were Indian nationals and the Indian government. Indian engineers designed the plant (Union Carbide's design was rejected), all the workers and managers at the plant were Indian, and all safety inspections were the responsibility of the Indian government. Furthermore, the lack of zoning restrictions allowed the building of residential housing (shanty towns) adjacent to the plant—a major factor in the harm caused to the population. The disaster was a great public relations problem for Union Carbide, and despite India's inability

Bhopal Disaster: On the night of December 3, 1984 an explosion at a Union Carbide plant in Bhopal, India resulted in the release of methyl isocyanate (MIC), a toxic chemical that injured about a half-million people and killed an estimated three thousand people.

Table 20.1 *Doing Business Internationally*: Foreign Direct Investment: Net Inflows (in Billions of Dollars)

Country	2010	2011	2012	2013
China	273	331	295	348
United States	259	257	218	295
Brazil	53	71	76	81
Hong Kong, SAR, China	83	96	75	77
Canada	28	40	39	71
Russian Federation	43	55	50	71
Singapore	55	50	61	64
Australia	35	64	54	52
Germany	86	88	50	51
Ireland	38	24	41	50
Mexico	26	24	18	42
India	27	36	24	28
Japan	7	−1	1	4
Hungary	−21	10	10	−4

Source: World Bank.

to bring a lawsuit in the United States due to jurisdictional grounds—Union Carbide India Limited was an independent company incorporated under the laws of India for which Union Carbide was a mere shareholder—Union Carbide still paid \$470 million in damages. Subsequently, it sold its interests in the company to Eveready Industries India.

FDI flows generally in the direction of large, untapped markets (emerging markets) and stable economies. This can be seen in the fall of FDI in Russia due to the perception of political and economic instability caused by Russia's invasion of Crimea and incursion into the Ukraine in 2014. In addition, the Russian regulatory laws became more unpredictable due to the Russian response to Western financial and economic sanctions. FDI in Russia had reached \$71 billion in 2013 and it decreased to about \$23 billion in 2014.¹ On the whole, the Russian economy shrank 4.6 percent from July 1, 2014 to June 30, 2015. This demonstrates the importance of legal and **macroeconomic stability** in drawing FDI. Investors dislike instability and uncertainty. Russia is an example of a country in which FDI inflows were on a rise, but is now seen as an unstable economy, where the risks of FDI are greater than the expected rewards. This instability not only caused a decrease in the inflow of FDI, it also resulted in *capital flight* (outward FDI) to more stable countries. The **Russian crisis** will be reviewed in-depth later in this chapter.

Hungary is another example where factors like corruption and political instability have had a major impact on the inward flow of FDI, so much so that in 2010 it had a negative FDI of \$21 billion and in 2013 a negative FDI of \$4 billion. A stark comparison is seen in the FDI inflows to Japan and Singapore. Japan, despite having one of the world's largest economies, drew in only \$4 billion in FDI, while Singapore, as city state with a much smaller population, benefited from \$64 billion of FDI in 2013. Why is this so? Both countries rate high on stability. However, Japan has a history of being insular and not open to FDI. Japan also has seen little growth beginning in the 1990s. In contrast, Singapore has had high rates of growth and has been friendly toward FDI.

The Russian crisis and the case of Hungary demonstrate that FDI is highly dependent on investors' sense of security and ease in doing business in a given country. Table 20.2 *Doing Business Internationally*: "Ease of Doing Business Rankings" shows the top-rated countries for ease of doing business, as well as a selection of other countries. The overall ranking is a summation of numerous ranking categories, which include ease of establishing a business (number of procedures required), ease in obtaining construction permits, legal protections afforded to minority investors, and severity of taxation.

Western and Central Europe are considered to be secure places for FDI. Figure 20.1 *Doing Business Internationally*: "Inward FDI as Percent of GDP" compares the amount of FDI in the **European Union (EU)**

FOREIGN DIRECT INVESTMENT

Table 20.2 Doing Business Internationally: Ease of Doing Business Rankings

Country	Ease of Doing Business	Starting Business	Construction Permits	Protecting Minority Investors	Taxes
Singapore	1	6	2	3	5
New Zealand	2	1	13	1	22
Hong Kong SAR	3	8	1	2	4
Denmark	4	25	5	17	12
South Korea	5	17	12	21	25
Norway	6	22	27	12	15
United States	7	46	41	25	47
United Kingdom	8	45	17	4	16
Finland	9	27	33	76	21
Australia	10	7	19	71	39
Malaysia	18	13	28	5	32
Taiwan	19	15	11	30	37
Thailand	26	75	6	25	62
Japan	29	83	83	35	122
Poland	32	85	137	35	87
Mexico	39	67	108	62	105
South Africa	43	61	32	17	19
Turkey	55	79	136	13	56
Italy	56	46	116	21	141
Russia	62	34	156	100	49
Vietnam	78	125	22	47	104
China	90	128	179	35	53
Philippines	95	161	124	124	50
India	142	158	184	186	137
Venezuela	182	182	152	79	165

Source: World Bank Group.²

EU	30.6
Ireland	157.1
UK	59.7
Poland	46.9
Spain	46.2
Germany	28.5
Italy	17.6
Greece	9.7

Figure 20.1 Doing Business Internationally: Inward FDI as Percent of GDP (2012).

and some of its countries relative to their GDP. The percentage of GDP measurement allows a more accurate comparison because it adjusts for the size of each country's economy.

Figure 20.1 shows as a percentage of GDP the EU is a major receiver of foreign investment, with Ireland drawing foreign investment equal to one and one-half times its GDP. The EU, one of the largest economies in the world (along with the United States and China), drew foreign investment equal to 30 percent of its GDP.

Types of Foreign Investment

FDI comes in numerous forms of doing business, such as the purchase (merger or acquisition) of a foreign company, establishing a company or foreign presence in a foreign country, or entering into a joint venture with another company in order to transact business in a foreign country. All three forms of FDI are commonly used, but the establishment of a foreign presence is the most common vehicle for a company wanting to enter a foreign market. Of course, purchasing a foreign company or joint venturing with a foreign company are also common ways of establishing a foreign presence.

Greenfield Investment

Instead of purchasing or merging with a foreign company, foreign investors may elect to begin a new business. **Greenfield** or *de novo* investment is when the investor creates and capitalizes a new company in the foreign country. The new company is incorporated under the foreign country's incorporation or company law. The true Greenfield investment entails establishing a company, purchasing land, and building a manufacturing plant. This type of investment is highly preferred by the host country because it creates value, employs workers, and adds to the national tax base. However, some countries place restrictions on the degree of ownership allowed to nonnationals. These restrictions on the amount of ownership interest allowed foreign parties are referred to as **equity participation requirements**. These restrictions vary widely across countries, with some countries having no such restrictions, while other countries severely restrict the percentage of ownership allowed to foreign parties. Most countries have more specific restrictions that only apply to ownership in vital industries, such as industries related to national security.

Portfolio Foreign Investment

FDI needs to be distinguished from other forms of foreign investment, such as **portfolio foreign investment** or **indirect foreign investment**. FDI involves conducting a business or business operations in a foreign country, while portfolio foreign investment refers to passive investments, such as the purchase of stocks and bonds of foreign companies. Passive investments mean that the investor does not partake in the active management of a foreign company. However, investments that acquire 10 percent or more of a foreign entity will often be regarded as "controlling" interests by government regulations and therefore recognized as a type of FDI. A controlling interest strips the investor of its passive investor status and subjects the investor to a wider range of the foreign country's laws. Also, certain passive investors may find common interests and agree to collaborate to intervene in the management of the company. This chapter focuses on FDI in which a domestic business seeks to expand its business into foreign markets and not merely seek to invest in foreign companies.

FDI Strategy and Methods

Depending on the industry sector and type of business, a FDI may be an attractive and viable option. However, companies often pursue a long-term strategy when entering foreign markets for their goods. They pursue a graduated risk approach by first pursuing a low risk market entry strategy such as exporting, followed by licensing, and finally with FDI.³ FDI is often the goal of a long-term corporate strategy to move from exporting to selling goods produced in the foreign country and selling the goods through local sales offices in that country. However, these categories of entering foreign markets are not always clear since a company may combine a variety of methods at the same time. For example, a company may primarily use the export method, but also hire employees in the foreign country to market and sell their goods to wholesalers or large companies.

FDI is vital to many economies, especially lesser-developed and emerging economies, because it can provide the financial, technological and managerial skills, information, goods, and services that promote growth and make a country more competitive internationally. For a company seeking access to foreign markets, FDI provides a means to gain such access and avoid certain barriers to trade, especially disguised ones (unfounded safety and health standards). FDI is also a means of increasing production capacity as a company expands. Often because of the risks of FDI (government regulations, corruption) companies elect to hedge those risks by pursuing coproduction, joint venture, licensing, and joint marketing arrangements with a company in the foreign country.

To stay competitive, for companies that primarily sell in their own domestic markets it is still important to be aware of whether competitors are expanding into foreign markets and what methods they are using to enter those markets. Often it becomes necessary to follow the expansion of competitors, especially if a company's major customers are also expanding overseas. The overwhelming majority of FDI is made in setting up or acquiring foreign companies in order to build, manufacture, or sell directly to the ultimate consumers. This investment is

achieved or accomplished mostly through mergers and acquisitions. In the case of traditional manufacturing, this has been the primary mechanism for investment.

More recently, there has been a dramatic increase in the number of technology startups. Instead of large company FDI, high-tech startups are small companies that have grown out of research and development projects and their major products are linked to intellectual property rights, such as a software programs or technology-based processes. Despite the rise of small technology companies, large companies continue to be the dominant players in foreign investment. This is because high-tech types of companies, especially those that produce intellectual property-type products, take a long time to develop and may go through many changes before the product is marketable. Thus, the capital investment in such enterprises is unknown as compared to traditional manufacturing, where the costs of equipment and machinery are known. Nonetheless, the expanded role of technology and intellectual property has changed the FDI playing field. Companies are still motivated to make investments in these areas, but because of the vagaries of technology investments, the portion of FDI in this area remains limited.

When the costs of production are uncertain and the marketability of products in a foreign country is uncertain, companies may elect to lower their risks in entering a foreign market through licensing or technology transfer arrangements. See Chapter 19 on “Intellectual Property Licensing.” Another alternative is the use of strategic or global alliances, such as, **reciprocal distribution agreements**, in which two companies within the same industry agree to act as distributors of each other’s products in their home countries. In this way, instead of having to build a foreign distribution network, each company gains access to the other company’s existing distribution system. Ancillary to such distribution agreements, the foreign distributor may agree to piggyback marketing of the other party’s products alongside its own products.

Piggyback Marketing is a cost-effective marketing strategy where two or more companies represent the other firm’s non-competing product in various promotions or through referrals. It is a strategy in which two or more businesses work together to market their complementary products. Sometimes lesser-known goods may piggyback on successful or well-known brands.

The other method of hedging risks in FDI is through **joint venture** arrangements with a foreign company. The common joint venture is between two companies, although more than two companies may form an alliance or syndicate. Alliances or **syndicates** are usually compiled for major construction or public works projects that require a wide variety of expertise and resources. The primary reason for a joint venture is to share the costs and risks of an FDI. Other reasons include: to gain access to **proprietary information** (intellectual property rights, know-how, trade secrets, and other types of confidential information); to gain access to foreign channels of distribution; and to exchange core competencies (innovation, marketing, production, and so forth).

Franchising as Alternative to FDI

For companies wanting to expand their core competencies (production of goods or sale of services), **franchising** has been a popular alternative to traditional FDI. As discussed in Chapter 3 on “Strategies for International Business,” there are different franchising arrangements: (1) direct franchising, (2) **area development agreements**, and (3) **master franchising**. Direct franchising involves a direct contractual relationship between the franchisor and each franchise location. In an area development agreement, the franchisor grants exclusive rights to a developer. The developer establishes multiple franchise locations within the geographical area provided in the development agreement and remains directly bound by contract to the franchisor; there are no third parties (sub-franchisees). Area developers are larger companies that have the

financial ability to develop an entire area rather than a single location. Such agreements are generally easier to terminate than a master franchise agreement. A master franchise agreement creates a chain of contractual relationships: franchisor >>> subfranchisor >>> subfranchisees. In the master franchise arrangement the master franchisee-subfranchisor has the power to grant franchise rights to other parties (subfranchisees). Master franchise agreements are most commonly used internationally to penetrate and rapidly expand in a foreign market. Such arrangements require less involvement by the franchisor, but at the same time, the franchisor loses direct control of the franchise locations. Also, in cases where the subfranchisor does not perform to expectations, it is more difficult to terminate a master franchise agreement than it is to terminate a direct franchise or an area development agreement.

Emerging Economies and the Russian Crisis

FDI varies dramatically from one country to the next based upon the combination of risks and rewards related to a given country. On the benefits side, factors include the size of the foreign economy, whether it is an “emerging economy,” whether there is a growing consumer market, the stability of the government, and the quality of the infrastructure. On the risk side, factors include lack of government guarantees of the security of the FDI, instability of the government, existence of hostilities within the country, high levels of corruption, weakness of the country’s currency, and weakness of the judicial system and the rule of law. Given the volatile nature of the international economy and the instability of some foreign countries, FDI can vary drastically over time.

The **BRIC countries** (Brazil, Russia, India, China) have had impressive periods of economic growth, but all have suffered, more recently, with major economic setbacks. Brazil’s growth has seen a severe decline, India and China have experienced slowing growth rates, but the most dramatic example has been the crisis in Russia, which entered a recession in late 2014. The Russian crisis provides an interesting case study on the vulnerability of the emerging economies as it shows how bad strategic decision-making and macroeconomic conditions can leave a country in a bad economic condition following years of economic growth. The Russian crisis will be analyzed in depth to show how countries remain vulnerable to economic and financial crises and decline. The analysis will look at the reasons behind the Russian debacle and how the interdependency of the world economy can prove both beneficial and detrimental. Finally, the analysis will look at the impact on FDI and capital flows of economic and political developments including war and hostilities, currency rate fluctuations, fluctuations in **world commodity prices**, and the failure to restructure inefficient economies.

In December 2014, the Russian Federation plunged into a financial and economic crisis that negatively affected the prospects of Russia and its partner countries (Belarus, Armenia, Kazakhstan, and Kyrgyzstan) in the areas of trade and investment. Before the outbreak of the crisis Russia was the ninth largest economy in the world. Russia played an important role in global FDI, both inbound and outbound. In 2013, inflows reached \$71 billion and outflows reached \$87 billion. The 2014–2016 crisis will inhibit economic growth in the Russian economy well into the future. First, there was a massive fall of the ruble on December 16, 2014. The ruble had been trading at 33 rubles per U.S. dollar and declined to 80 rubles per dollar on December 17, 2014. The fall in the ruble resulted in a massive increase of interest rates. On December 16, 2014, the Russian central bank increased its key interest rate from 10.5 percent to 17 percent in order to encourage people to keep money in the banks. This subsequently led to a spike in inflation and a drop in GDP.⁴

The crisis was exacerbated by underlying structural problems of the Russian economy, mostly due to over-reliance on oil and gas production for revenues and the failure to use those revenues to diversify the Russian economy, which made it vulnerable to the shock of a rapid decline of oil prices on world markets. The price of Crude Oil Brent (ICE) oil started to drop in August 2014, from a peak of \$108 to around \$50 by the end of the year, and below \$40 by late 2015, and bottoming out in January 2016 at about \$32. Russia became an example of a country with enormous scientific and technological potential failing to use its oil and gas revenues to transform that potential into a more developed economy. The annexation of Crimea in March 2014, and military involvement in the ongoing conflict in Eastern Ukraine, placed a further strain on government revenues. The annexation of Crimea and intervention in Eastern Ukraine was condemned by the international community, resulting in the imposition of economic sanctions by the EU and the U.S., resulting in a steep decline in inward foreign investment and a flight of

The interdependency of national economies makes almost all countries subject to economic disruptions no matter where they occur in the world. Lesser-developed countries and emerging economies are more susceptible and have lesser ability to recover. In other ways, countries have a role in their vulnerabilities in order to make themselves less susceptible to changes in macroeconomic conditions. An example has been the inability of Russia and other former Soviet-bloc countries to restructure their economic systems in transitioning to market economies. Bulgaria continues to be unable to attract needed FDI due to high levels of corruption. The near collapse of the Greek economy can be traced to low rates of productivity, a government-dependent labor force, and unsustainable debt.

Russia provides an example of a country once thought to be on its way to economic prosperity, as a BRIC country, due to its oil and gas producing sector as well as large FDI inflows. Instead, a combination of forces, including Western economic and financial sanctions levied in response to Russia's invasion of Crimea and intrusions into the Eastern Ukraine and an unprecedented collapse in world oil prices have resulted in a negative economic outlook for the near future. This negative outlook is further supported by an outflow of FDI and the collapse of the Russian ruble, dramatically reducing consumer purchasing power.

The Guardian (February 28, 2014)

Russia and the west are on a collision course over Crimea after Moscow was accused of orchestrating a "military invasion and occupation" of the peninsula. Russia annexed Crimea on March 18, 2014, violating the 1994 *Budapest Memorandum* signed by the Russian Federation, United States, and the United Kingdom, which ensured the territorial integrity and political independence of the Ukraine.

The Economist, "The Russian Economy" (November 22, 2014)

Russia's economy is teetering on the verge of recession. The central bank says it expects the next two years to bring no growth. Inflation is on the rise. The ruble has lost 30% of its value since the start of the year, and with it the faith of the country's business community. Banks have been cut off from Western capital markets, and the price of oil—Russia's most important export commodity—has fallen hard. Consumption, the main driver of growth in the previous decade, is slumping. Money and people are leaving the country.

Russia's response to Western sanctions, aimed at its financial sector, led to a less business friendly environment through the

imposition of new regulations. These economic shocks led to substantial outflows of capital (reverse FDI). In 2013, FDI in Russia reached a record \$94 billion, making it the third most attractive country for investors, behind the United States and China. In one short year, FDI into Russia hit a record low of −\$1.06 billion in the fourth quarter of 2014.

A bigger shock was the ahistorical drop in oil prices, the major source of Russian capital and taxes (oil and natural gas account for about 30 percent of Russia's GDP and 60 percent of its export earnings), from about \$108 per barrel to \$42 per barrel from 2013 to 2014. First-quarter 2015 statistics showed GDP growth at −2 percent and inflation at 16.5 percent. The Russian ruble lost about half of its value in the second half of 2014, contributing to increased capital outflows.⁵

Moscow Times (May 18, 2015)

Overseas investment by Russian companies fell to \$56 billion last year, a 40 percent decline from 2013, even as China led a wider boom in foreign direct investment from emerging economies, according to a report by the United Nations Conference on Trade and Development (UNC-TAD). While Russia slipped down the rankings, foreign direct investment from China and Hong Kong boomed to \$266 billion last year, an increase of 38 percent from the \$193 billion recorded by UNCTAD in 2013.

In principle, the decline of the Russian currency should stimulate new inward FDI because things will be cheaper to buy, and discourage outward FDI, especially by natural resource-based firms, which have also suffered by the fall in oil prices. However, investors, including Russians, will seek safer and less volatile places to place their money. As noted above, to attract capital Russian banks increased interest rates to above 15 percent, but that also depressed domestic spending and capital projects because of the high costs of borrowing. Russia ranks as one of the worst countries for economic freedom with a 2016 score of 50.6 out of 100, with recent declines in monetary freedom, property rights, and the management of government spending. It ranks 153 out of 178 indexed countries according to www.heritage.org/index/ranking.

Bloomberg (June 5, 2015)

Foreign direct investment flows to Russia will fall to half of last year's level in 2014 as the conflict with Ukraine prompts companies to delay expansion, the Vienna Institute for International Economic Studies said. A key factor being "the Ukraine–Russia conflict, which depresses economic growth and increases investment risk in the affected countries."

Figure 20.2 *Doing Business Internationally: Economics of FDI: Russian Economic and Currency Crisis.*

capital out of Russia. The increasingly hostile Western attitude towards Russia will continue to hinder both inward and outward FDI. Over the first three quarters of 2014 FDI inflows declined by more than 60 percent from \$62 billion to \$24 billion from the previous year; a further deep decline in FDI continued in 2015.

Crack in the BRICs

The Russian crisis worsens the prospects of the BRIC countries, as it exposes the structural vulnerabilities of their economies. An alternative view is that Russia is an isolated case and does not bear on the future prospects of the other BRIC countries. The truth is somewhere in the middle; because of the size of the populations of India, China, and Brazil and the potential of their consumer markets they still remain likely to grow into more mature, stable economies, especially in the case of China. The Russian crisis was caused mostly by the past economic decisions and the decision to invade the Ukraine. However, Russia's crisis also is a lesson to other emerging economies that they must use their new revenues to restructure their economies, to continue to privatize their industries, open their markets, diversify their economies, and invest in education and research and development.

Russia's reemergence as a strong economy will depend on its building stronger relations with other BRIC countries, especially China. This will come first as Russia seeks to switch its energy markets away from Europe and towards China. In the short term at least it will weaken the prospects of the **Eurasian Economic Union**, promoted by Russia and including Armenia, Belarus, Kazakhstan, and Kyrgyzstan. See Figure 20.2 *Doing Business Internationally*: "Economics of FDI: Russian Economic and Currency Crisis".

As noted earlier in the chapter, "ease in doing business" is an important variable for a country attempting to attract FDI. This common-sense relationship between ease in doing business and FDI seems to be contradicted by the vast inflows of FDI into China. China ranked 90th in the overall ease of doing business, but was first in 2013 FDI inflows totaling \$348 billion, with the U.S. second at \$295 billion. One explanation is that Chinese government is not as homogeneous as is perceived. Most business licensing and permits are issued at the local and provincial levels. Tables 20.3, 20.4, and 20.5 show the overall ease of doing business at the regional level, the ease of enforcing contracts, and the ease in establishing a business. Table 20.3 show Guangzhou, Shanghai, Nanjing, Hangzhou, and Jinan as being the most business friendly cities, while Changsha, Hefei, Guiyang, and Lanzhou being the least friendly.

The number of procedures to enforce contracts through the Chinese court system is identical in all regions (31 procedures), but the amount of time it takes to execute those procedures and the cost of pursuing a breach of contract claim varies widely among the regions. It takes only 235 days to process a claim in Xi'an, while on average

Table 20.3 China's Regional Rankings

City	Starting Business	Registering Property	Enforcing Contracts
Beijing	6	12	9
Changsha	22	24	27
Chongqing	17	9	8
Guangzhou	3	2	1
Guiyang	30	28	24
Hangzhou	1	7	3
Hefei	27	17	26
Jinan	4	4	5
Lanzhou	29	29	30
Nanjing	2	5	2
Shanghai	5	1	4
Xi'an	25	10	5
Xining	23	19	28
Zhengzhou	12	27	16

Source: World Bank Group (2008).

Table 20.4 China's Regional Rankings: Enforcing Contracts

<i>Region</i>	<i>Procedures (Number of)</i>	<i>Time (Days)</i>	<i>Cost (% of Claim)</i>
Beijing	31	340	9.6
Guangzhou	31	120	9.7
Lanzhou	31	440	29.9
Shanghai	31	397	17.1
Xi'an	31	235	21.7
Xining	31	458	24.8
Zhengzhou	31	285	31.5

Source: World Bank Group (2008).

Table 20.5 China's Regional Rankings: Start a Business

<i>Region</i>	<i>Procedures (Number of)</i>	<i>Time (Days)</i>	<i>Cost (% Income per Capita)</i>
Beijing	14	37	3.2
Guangzhou	13	28	6.3
Guiyang	14	50	26.6
Lanzhou	14	47	14.1
Shanghai	14	35	4.8
Xi'an	14	43	15.2
Xining	14	51	12.0
Yinchuan	14	55	12.0
Zhengzhou	13	41	11.6

Source: World Bank Group (2008).

it takes 458 days in Xining. The cost of pursuing a claim as a percentage of the claim amount is 9.6 percent in Beijing and a whopping 31.5 percent in Zhengzhou.

For ease of establishing or starting a business it can take on average 28 days to start a business in Guangzhou and twice that amount of days in Yinchuan. The costs of starting a business are cheapest in Beijing and Shanghai.

Managing the Risks of FDI

This section looks at ways FDI has been made safer through public and private means. It begins at the macro level with a brief review of the WTO's **Agreement on Trade-Related Investment Measures (TRIMs)**, before discussing country-to-country FDI protection agreements known as **bilateral investment treaties (BITS)**, to private–public (company to government) negotiated investment protections known as **concession agreements**, and the management of investment risks through private joint ventures, before concluding the section with notes on the role of competition (antitrust) law on FDI.

WTO's Agreement on Trade-Related Investment Measures (TRIMs)

The **Agreement on Trade-Related Investment Measures (TRIMs)** provide a general framework of rules and core standards for national laws and regulations relating to the treatment of foreign investors. Policies such as local content requirements and trade balancing rules that have been used to protect and promote the interests of domestic industries are prohibited. The TRIMs Agreement is one of the five principal legal agreements of the WTO treaty, along with the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), the Agreement on the Application of Sanitary and Phytosanitary Measures (SPS), and the Agreement on Technical Barriers to Trade (TBT).

TRIMs prohibit national rules that give preferences to domestic firms in order to allow foreign companies to be able to compete in the marketplace. The result has been a substantial increase in world FDI beginning in the late 1980s. However, some countries continue to place restrictions on FDI, such as limiting the repatriation of investment profits in order to prevent the outflow of foreign exchange reserves. Other types of restrictions include: (1) local content requirements and manufacturing requirements (require the use of domestically manufactured materials and components); (2) trade balancing requirements; (3) domestic sales requirements; (4) technology transfer requirements; (5) export performance requirements (require the export of a specified percentage of the goods produced); (6) local equity restrictions; and (7) employment restrictions (must hire minimum percentage of local workers). Many of these restrictions are prohibited under WTO rules. Nonetheless, the foreign investor should research the existence of such restrictions before investing in a foreign country.

Outside of the WTO, there are regional organizations involved in lowering barriers to trade and FDI, such as the **Asia-Pacific Economic Cooperation (APEC)**, established in 1989, which is a forum for 21 “Pacific Rim” countries including: Australia, Canada, Chile, China, Indonesia, Japan, Malaysia, Mexico, New Zealand, Peru, the Philippines, Russia, Singapore, South Korea, Thailand, the United States, and Vietnam. APEC’s goal is to promote free trade and foster a regional trading bloc, and to establish new markets for agricultural products and raw materials. The high point of APEC activities is an annual meeting of the leaders of APEC member countries. The attending leaders dress in the “national costume” of the host country (see Image 20.1: “2014 APEC Meeting of Leaders in China”).

Bilateral Investment Treaties (BITs)

BITs are the successor to the nineteenth-century Friendship, Commerce and Navigation Treaties (FCN) that were used to open Asian ports to Western commerce. A BIT is an agreement establishing the terms and conditions for private investment or FDI by nationals and companies of one country in another country. Most BITs grant foreign investors from the other BIT country a number of guarantees, which typically include fair and





Images 20.1 2014 APEC Meeting of Leaders in China.

equitable treatment, protection from expropriation, and free transfer of capital. The distinctive feature of many BITs is that they allow for an alternative dispute resolution mechanism, whereby an investor whose rights under the BIT have been violated has recourse to international arbitration, commonly through the **International Centre for Settlement of Investment Disputes (ICSID)**, rather than being forced to litigate using the host country's courts

The ICSID is an international arbitration institution that settles investment disputes between foreign investors and host countries. As well as arbitration, it offers conciliation services. The ICSID is a member of the World Bank, from which it receives funding, and is headquartered in Washington, D.C. It was established in 1966 as an independent, specialized institution to encourage the international flow of investment and mitigate noncommercial risks. As of 2016 there were 161 member countries of the ICSID. Contracting member states agree to enforce and uphold arbitral awards in accordance with the ICSID Convention.

Alternative Dispute Resolution (ADR) includes mediation, conciliation, and arbitration. *Conciliation* is a process in which parties to a dispute use a conciliator who meets with the parties both separately and together in an attempt to resolve their differences. They do this by lowering tensions, improving communications, interpreting issues, and encouraging parties to explore potential solutions. Conciliation differs from arbitration in that the conciliation process, in and of itself, has no legal standing, and the conciliator usually has no authority to seek evidence or call witnesses, usually writes no decision, and makes no award. *Mediation* is purely facilitative: the mediator has no advisory role. Instead, a mediator seeks to help the parties to develop a shared understanding of the conflict and to work toward building a practical and lasting resolution. One significant difference between conciliation and mediation lies in the fact that conciliators possess expert knowledge of the area in which they conciliate. The conciliator can make suggestions for settlement terms and can give advice on the subject of the dispute. Conciliators may also use their role to actively encourage the parties to come to a resolution.

BITs have been a core method of some countries to safeguard the foreign investments of their domestic companies. It is also a way for countries to insure the safety of inward FDI in order to attract much needed foreign capital. The U.S. and China have been active in expanding the number of countries in which they have entered into BITs. The U.S. Department of State lists the six core principles of its *Model BIT*. First, BITs provide that investors and their **covered investments** (investments of a national or company in the territory of the other BIT country) are entitled to be treated as favorably as the host country treats its own investors and equal to the treatment received by investors from other countries. Thus, the Model incorporates the WTO **national treatment** and **most-favored-nation principles** as discussed in Chapter 6. This treatment must cover the full life cycle of investment, from its establishment or acquisition, through its management, operation, and expansion, to its disposition or liquidation.

Second, BITs establish clear limits on the expropriation of investments and provide for prompt payment of adequate and effective compensation when expropriation takes place. Third, BITs require the free transferability of funds into and out of the host country without delay using a market rate of exchange. This covers all transfers related to a covered investment and creates a predictable environment guided by market forces.

Fourth, the circumstances in which **performance requirements** can be imposed are limited. Performance requirements require covered investments to adopt inefficient and trade-distorting practices, such as local content requirements or export quotas as a condition for the establishment, acquisition, expansion, management, conduct, or operation of a business.

Fifth, BITs give investors the right to submit an investment dispute with the treaty partner's government to international arbitration. There is no requirement to use that country's domestic courts. Sixth, BITs give covered investments the right to engage the top managerial personnel of their choice, regardless of nationality.

The U.S. has negotiated BITs with numerous countries as shown in Table 20.6 *Doing Business Internationally: "U.S. Bilateral Investment Treaties."* The figure only shows the countries where the BIT agreement is in actual force. There are a number of countries, most notably Russia, with whom the U.S. has negotiated a BIT agreement that has not entered into force due to a lack of ratification by one or both of the countries. The country of Bolivia has been the only country to rescind a BIT with the U.S., effective June 10, 2012. According to Table 20.6, the first U.S. BIT went into force on March 3, 1989 with the country of Grenada. The most recent BIT went into force on January 1, 2012 with Rwanda.

Table 20.6 *Doing Business Internationally: U.S. Bilateral Investment Treaties*

Albania	January 4, 1998	Kazakhstan	January 12, 1994
Argentina	October 20, 1994	Kyrgyzstan	January 12, 1994
Armenia	March 29, 1996	Latvia	December 26, 1996
Azerbaijan	August 2, 2001	Lithuania	November 22, 2001
Bahrain	May 30, 2001	Moldova	November 25, 1994
Bangladesh	July 25, 1989	Mongolia	January 1, 1997
Bulgaria	June 2, 1994	Morocco	May 29, 1991
Cameroon	April 6, 1989	Mozambique	March 3, 2005
Congo, Democratic Republic of	July 28, 1989	Panama	May 30, 1991
Congo, Republic of the	August 13, 1994	Poland	August 6, 1994
Croatia	June 20, 2001	Romania	January 15, 1994
Czech Republic	December 19, 1992	Rwanda	January 1, 2012
Ecuador	May 11, 1997	Senegal	October 25, 1990
Egypt	June 27, 1992	Slovakia	December 19, 1992
Estonia	February 16, 1997	Sri Lanka	May 1, 1993
Georgia	August 17, 1997	Trinidad & Tobago	December 26, 1996
Grenada	March 3, 1989	Tunisia	February 7, 1993
Honduras	July 11, 2001	Turkey	May 18, 1990
Jamaica	March 7, 1997	Ukraine	November 16, 1996
Jordan	June 12, 2003	Uruguay	November 1, 2006

In 2012, the U.S. published a *new Model Bilateral Investment Treaty*. A brief review of the Model BIT shows the principles, objectives, and substance of the BIT. The BIT references the 1994 WTO Agreement, TRIPS Agreement, GATS Agreement, and the **New York Convention** (United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards).

Core Principles

The BIT adopts the core principles of GATT—national treatment principle, most-favored-nation principle, and the principle of transparency as discussed in Chapter 5, as well as the minimum standard of treatment principle.

- **National Treatment Principle:** Each country shall accord to investors of the other country treatment no less favorable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory.
- **Most-Favored-Nation Principle:** Each party shall accord to investors of the other country treatment no less favorable than that it accords, in like circumstances, to investors of any other country.
- **Minimum Standard of Treatment Principle:** Each country shall accord to covered investments treatment in accordance with customary international law, including **fair and equitable treatment** and full protection, security, and due process as embodied in the principal legal systems of the world.
- **Transparency Principle:** Each country shall ensure that its laws, regulations, procedures, and administrative rulings of general application, as well as its judicial decisions respecting any matter covered by the BIT are promptly published or otherwise made publicly available.

A key component of the Model BIT deals with the issues of **expropriation** and foreign country regulations. In the area of expropriation and compensation, the three core concepts include: (1) conditions in which expropriation or nationalization are deemed appropriate (expropriated for a public purpose or for the public welfare); (2) prompt payment of compensation; and (3) calculation of just compensation. First, expropriation or nationalization is only appropriate under the following conditions: taken for a public purpose; in a nondiscriminatory manner; with payment of prompt, adequate, and effective compensation. The taking of property for a public purpose is similar to the taking of private property under the *eminent domain* power in the U.S. Constitution. By nondiscrimination, a country should not specifically take property from companies from certain countries and not others.

Expropriation and Nationalization: The process of expropriation occurs when a public agency takes private property for a purpose deemed to be in the public interest. International law recognizes the right of countries to seize private property to further national welfare, but it requires that both citizens and foreigners be treated in the same manner. The issue of just compensation in return for expropriated property differs from country to country. The United States and most Western countries maintain that the expropriating country should pay prompt, adequate, and effective compensation. **Nationalization** is the process of taking by a national government of an entire private industry into public ownership. In the past, industries commonly subject to nationalization include transport, communications, energy, banking and natural resources. The opposite of nationalization is *privatization*, which involves the sale of government property or assets.

The condition of prompt compensation means that payment should be made without delay; be equal to the fair market value of the expropriated investment (property); cannot reflect any change in value occurring because the intended expropriation had become known earlier; and be fully realizable and freely transferable. Furthermore, the payment must be made in a freely usable currency.

The Model BIT also recognizes two types of expropriation—direct and indirect or **creeping expropriation**. Direct expropriation involves the formal transfer of title or seizure of the property. Creeping expropriation involves

a country taking a series of actions, such as passing laws that diminish the value of an investor's investment or control over its investment, such as severely increasing regulations, taxes, and equity participation requirements, that has an effect equivalent to direct expropriation.

Protection of Environment and Workers' Rights

The Model BIT makes clear that the host country should not offer to reduce environment and workers' protections in order to attract investors and that investors should not accept the relaxation of such protections as a condition for investment. Each country is obligated not to waive its environmental laws in a manner that weakens or reduces the protections afforded in those laws, or fail to effectively enforce those laws through a sustained course of inaction. In the area of workers' or labor rights, the countries to the BIT obligate themselves to obeying the International Labour Organization's (ILO) **Declaration on Fundamental Principles and Rights at Work**. Labor rights include the areas of freedom of association; effective recognition of the right to collective bargaining; elimination of all forms of forced labor; effective abolition of child labor; elimination of discrimination in respect to employment; and acceptable conditions of work with respect to minimum wages, hours of work, and occupational safety and health.

Dispute Resolution

In the event of an investment dispute, the investor and the government should initially seek to resolve the dispute through consultation and negotiation, which may include the use of nonbinding mediation and conciliation. If the dispute cannot be resolved through negotiation, then a disputing party may submit the dispute to arbitration. The claimant must wait until six months have elapsed since the time of the event that gave rise to the claim. The claimant has four choices regarding the place and rules of arbitration: (1) if both parties are members of the ICSID Convention, a claim may be filed under the ICSID Rules of Procedure for Arbitration Proceedings; (2) if only one of the parties is a member of the ICSID Convention, then a claim can be brought under the ICSID's **Additional Facility Rules**; (3) a claim may be brought under the UNCITRAL Arbitration Rules (arbitration rules of the United Nations Commission on International Trade Law); or (4) the parties may agree to any other arbitration institution, such as the International Chamber of Commerce.

Most BITs also allow country-to-country dispute settlement through arbitration. For example, the two countries to a BIT may have different interpretations of the meaning of a BIT provision. In such cases, the countries must attempt to resolve the dispute through consultations and negotiations. If they fail to voluntarily agree to a solution, then either party may submit the dispute to arbitration as provided for in the BIT. In the event that the BIT fails to select a set of arbitration rules, then the UNCITRAL Arbitration Rules will govern.

Additional Facility Rules authorizes the Secretariat of ICSID to administer certain categories of proceedings between States and nationals of other States that fall outside the scope of the ICSID Convention. These proceedings include (i) fact-finding proceedings; (ii) conciliation or arbitration proceedings for the settlement of investment disputes between parties one of which is not a Contracting State or a national of a Contracting State; and (iii) conciliation and arbitration proceedings between parties at least one of which is a Contracting State (ICSID member) or a national of a Contracting State for the settlement of disputes that do not arise directly out of an investment, provided that the underlying transaction is not an ordinary commercial transaction.

The most important forum for investor-country disputes, the use of the ICSID, is discussed in the next section.

International Centre for Settlement of Investment Disputes

The World Bank established an arbitral venue, ICSID, where private companies may bring claims against national governments. The large role of BITs in increasing FDI is due in large part to the impact of the ICSID.⁶ It created the

“model of commercial style arbitration for investor–country disputes.” Under the commercial arbitration model, the ICSID has evolved as a venue based upon party-appointed arbitrators, confidential hearings, fast and final decisions without a right to appeal, and with a focus on the awarding of money damages and not intervening to force performance of the contract.

In *Asian Agricultural Products Ltd (AAPL) v. Republic of Sri Lanka*,⁷ an ICSID arbitration panel held that the right to arbitrate is not found in the parties’ contract, but is found in the BIT, in this case the United Kingdom–Sri Lanka BIT. The panel reasoned that the BIT serves as an ongoing offer by the country to arbitrate and the investor’s filing of a notice of arbitration serves as an acceptance. The ICSID tribunal held that: “The present case is the first instance in which the ICSID had been confronted with an arbitration request exclusively based on a treaty provision and not in implementation of a freely negotiated arbitration agreement directly concluded between the Parties among whom the dispute has arisen.” Thus, instead of needing the country to voluntarily agree to an arbitration submission, a company may directly file a claim with the ICSID.

Investment Arbitration and Parallel Proceedings

As noted above, the major trend that has made FDI less risky is the use of commercial arbitration-like dispute resolution in which the investor is able to file claims against a host country (country of investment).⁸ This has been largely due to the incorporation of provisions in BITs and free trade agreements (FTAs) that allow investor claims to be filed with private arbitration associations. Also, large foreign investors may lobby their home government (country of investor) to file a claim against the host country for violating the WTO Agreements, while at the same time pursuing investment arbitration, under a BIT or FTA. The difference is the government pursues a WTO **trade claim**, while the individual company pursues an **investment claim**. This approach provides the investor two chances at winning relief from the action or inaction of a foreign government and is referred to as **parallel proceedings**. Examples include:

- An import ban on goods or services may give rise to a claim of an indirect expropriation under an investment treaty (BIT) and a quantitative restriction in violation of GATT.
- An improper denial of a license to establish a business may result in a market access violation under GATS, as well as an arbitration claim under an FTA.
- The imposition of performance requirements may give rise to a claim under the TRIMs and a BIT claim.
- Disguised trade barriers (inappropriate quality, safety, licensing standards) may lead to a WTO national treatment claim or a BIT claim for fair and equitable treatment.⁹

For a further analysis of the concept of parallel proceedings see Figure 20.3 *Comparative Law*: “Tobacco Packaging in Australia.”

Concession Agreement

A **concession agreement** is a negotiated contract between a company and a government that gives the company the right to operate a specific business within the government’s jurisdiction, subject to certain conditions. For example, a government that is looking to attract mining companies to an impoverished area may offer significant inducements, such as tax breaks and a lower royalty rate. The term “concession agreement” is used in two slightly different ways in the business world. Both refer to a type of negotiated contract, which gives a company the right to do business, with some specific requirements. In one sense, it refers to a contract between a foreign company and a government in which the government signs a concession agreement to guarantee certain conditions, such as no changes in the income tax rate applicable to the foreign company, in order to attract the foreign company to invest in its country. In a second sense, this type of agreement may include the foreign company (concessionaire) the exclusive right to do business in a particular area or venue in exchange for some carefully negotiated terms.

A claimant filed parallel claims under the WTO Agreement and a BIT relating to an Australian law (**Australian Tobacco Plain Packaging Act**) that prohibits the branding of tobacco products and regulates almost every aspect of the appearance, size, and shape of the packaging, with civil and criminal penalties for importing, packaging, or manufacturing noncompliant products. Such measures have prompted both trade and investment litigation. The countries of Ukraine, Honduras, and the Dominican Republic have filed claims under the WTO's TRIPs Agreement arguing that the law: (1) unjustifiably diminishes the value of trademarks, (2) prevents owners from enjoying the rights conferred by trademark, and (3) fails to provide effective protection against unfair competition with respect to geographic indications (country of origin). At the same time, tobacco company Philip Morris brought a BIT claim in arbitration against Australia alleging that the law constitutes an unlawful expropriation of its intellectual property, violates fair and equitable treatment, guarantees of full protection and security, and umbrella clause guarantees.¹⁰

Umbrella Clause (in BITs) protects investments by bringing obligations or commitments, such as independent investment contracts between a foreign company and a host country, within the protective umbrella of the BIT. Investors often rely on an umbrella clause as a catch-all provision to pursue claims when a host state's actions *do not* otherwise breach the BIT. For example, is a simple breach of contract claim between a country and a foreign company within the scope of a BIT? This is a controversial issue on which courts have made contradictory decisions. A second issue is, even if the contract comes within the BIT, should a contract dispute be arbitrable under the BIT in con-

flict with a forum selection clause found in the contract?

The tobacco industry also filed suit in the Australian courts. The Australian Supreme Court has already weighed in regarding the constitutionality of the law, finding that "the mere restriction on a right of property or even its extinction do not necessarily mean that a proprietary right has been acquired by another." Trade and investment tribunals must now determine whether their rules protecting intellectual property rights can accommodate exceptions for health and public safety. The WTO Agreements incorporate general exceptions relating to the protection of human health and safety, but the BIT includes no such exception. Under WTO rules and in the BIT arbitration, the Australian government will have the burden of proving that plain packaging demonstrably alters consumer behavior.

Parallel proceedings in the plain packaging context illustrate a willingness by multinational corporations to pursue all possible avenues of relief in response to government regulation. To maximize their chances of success, companies have to think strategically. In this case, Philip Morris restructured its investment by using its Hong Kong-based Philip Morris Asia affiliate in order to take advantage of the Hong Kong–Australia BIT protections and its failure to have an exception for human health and safety. The tobacco industry acted strategically to find countries willing to initiate WTO proceedings on its behalf. It is funding the Ukraine WTO proceeding. Win or lose, the tobacco companies have successfully delayed the enactment of plain packaging laws in the EU, Canada, and New Zealand pending the Australian litigation. Further, since there is no precedent (*stare decisis*) in trade litigation or investment arbitration even if it loses the Australian proceedings, the tobacco industry can re-litigate the same question against other countries that enact plain packaging laws.

Figure 20.3 Comparative Law: Tobacco Packaging in Australia.¹¹

In sum, when businesspersons talk about contracts with foreign companies, a concession agreement is worked out between the company and the government of the nation where it wishes to do business. The government may want to incentivize the company by lowering taxes, relaxing restrictions, or providing other incentives. In cases where the government is not as enthusiastic, the company may need to make some concessions such as ceding some of the profits to the government or paying a special tax rate which may be higher than that of domestic businesses. Once the agreement is negotiated and signed, the company has the right to do business locally under the terms of the agreement.

Joint Ventures

In some cases, joint ventures provide the best manner of obtaining foreign trade income. International joint ventures are used in a wide variety of manufacturing, mining, and service industries, and they frequently involve technology licensing by one company to the joint venture. Host country laws may require that a certain percentage (sometimes as much as 51 percent) of manufacturing or mining operations be owned by nationals of that country, thereby limiting foreign companies' local participation to minority ownership of joint ventures. Despite such legal requirements, a foreign company may find it desirable to enter into a joint venture with a domestic company to help spread the high costs and risks frequently associated with foreign operations. The local partner will likely bring to

the joint venture its knowledge of the customs and tastes of local consumers, an established distribution network, and valuable business and political contacts.

There are disadvantages to international joint ventures. A major potential drawback, especially in countries that limit foreign companies to minority participation, is the loss of effective managerial control. As a result, the foreign investor may experience reduced profits, increased operating costs, inferior product quality, exposure to product liability, and environmental litigation and fines. Foreign companies or investors that wish to retain effective managerial control will find this issue important in negotiations with the prospective joint venture partner and the host government.

Foreign companies contemplating international joint ventures should consider retaining experienced counsel in the host country. Since the interests of a prospective partner may not always coincide with that of the foreign company, relying on a potential partner in a joint venture to negotiate host government approvals and to give advice on legal issues could put the foreign joint venture partner at a disadvantage with the host country partner. Qualified foreign counsel, however, can be very helpful in obtaining government approvals and providing ongoing advice regarding the host country's intellectual property, tax, labor, corporate, commercial, antitrust, and exchange control laws.

Strategic Joint Venturing

Joint venture agreements should, and are often, highly customized contracts.¹² The structure and content of such arrangements may make one partner susceptible to the other party gaining a strategic advantage. This is especially true when the joint venture involves otherwise competing companies. The interfirm collaboration anticipated by the partners in a joint venture can be threatened when one of the partners attempts to gain additional benefits, often not in the interest of the other partner or the joint venture. For example, one partner may provide confidential information to assure joint venture success. The fear is that the contributed information will be taken by the other partner to gain competitive advantages outside of the joint venture. This is especially a concern in high-technology international joint ventures where there is a substantial exchange and use of proprietary information. If the purpose of the joint venture is the promotion of mutual interests through the joint venture enterprise, then it is vital that the joint venture agreement provide means to deter one party taking advantage of the other or taking the confidential information produced by the joint venture for personal use.

Proprietary Information: Information that is not public knowledge, such as financial data and product test results. The information is viewed as the private property of the creator or holder. Therefore, someone who receives the information, such as a subcontractor or joint venturer, is under a duty to keep the information confidential and not make unauthorized use of the information. The term *proprietary information* is often used interchangeably with the term *trade secret*.

The joint venture should include a carefully worded *purpose clause*, which defines the scope of the venture. Whether the clause should be tightly or narrowly drawn or whether it should be open and flexible in its mandate depends on the nature of the enterprise. A single project venture (building a highway) may dictate a narrow clause. The joint venture agreement should also include "incentive schemes" to encourage venture-enhancing conduct by individual partners, such as structuring rewards for partner conduct that confers benefits on the joint venture. The incentive may consist of an additional portion of the profits or being granted extended licensing privileges of the joint venture's products.

Other methods or techniques to increase collaboration and deter bad behavior by partners include: (1) substantial mutual investment, (2) creation of an interlocking board of directors directorate, and (3) assignment of key personnel to the joint venture. If both parties have substantial sunk costs invested in the venture, then they will be more

willing to collaborate in order to recoup their investments. When one party invests substantially more capital than the other party, the other party may use that imbalance to try to renegotiate more favorable terms. The benefits of a board of directors made up of representatives or managers from the parent companies leads to trust-building and greater cooperation. Finally, companies often hesitate to allocate their best personnel to the joint venture project. In order to increase the likelihood of success, however, it is important for both partners to assign key personnel to the venture.

Finally, a strategically drafted joint venture agreement addresses the issue of dispute resolution. A well-worded dispute resolution clause provides a problem-solving framework to deal with disputes internally. For example, an internal dispute resolution committee made up of managers that came from the different parent companies should attempt to resolve disputes through negotiations and consensus. If this fails, then the agreement should provide for an amicable method of terminating and unwinding the business through good faith negotiation, mediation, and arbitration. The next section deals with the important issue of the joint venture agreement providing strategies for partners to exit the joint venture.

*Exit Strategies for International Ventures*¹³

This section demonstrates the complexity of the issue of exiting from a joint venture. It is vital to preplan for such eventualities in the joint venture agreement. Dissolution of a joint venture can lead to prolonged litigation. Accordingly, it makes business sense for the parties to consider exit strategies at the time of the formation of the venture. The following material discusses various types of exit strategies and related provisions that can be inserted into the joint venture agreement.

- **Russian Roulette or Mexican Shoot-Out** provision allows one partner to name a price at which the partner is willing to sell his interest in the joint venture to the other partner. The other party must either agree to buy at the offered price or has to sell its interest at the offering price.

The problem with this strategy is that a partner that really wants to exit the joint venture does not want to be faced with the possibility that it will be forced to buy the other partner's interest and have to take over the entire venture.

- **Right of First Refusal** is the most commonly used exit strategy. There are a number of variations of the right of first refusal depending on how many venturers are included. The right is triggered when one of the partners receives an offer from a third party to buy its ownership interest. At that point, the partner, before accepting the offer, must first offer to sell its interest to its joint venture partner or partners at the offered price and upon the terms set forth in the third-party offer. If the other partners decide against buying the other partner's interest, then that partner is free to sell its interest to the third party. Often this strategy is teamed with the drag-along or tag-along provision discussed below.

A variation of the right of first refusal is the **Right of First Offer**, which is more flexible and less restrictive on the party wanting to exit the joint venture. This strategy allows a partner wanting to exit the venture to make an offer to sell to the other partners at a price and terms which it deems appropriate. If the partners cannot reach an agreement, the partner is free to go to the market and attempt to sell its interest on terms no less favorable than it offered to the other partners. If the partner reaches an agreement to sell on more favorable terms or at a lower price, then it is required to give the other partners another opportunity to buy its interest under a right of first refusal.

- **Drag-Along** strategy benefits majority interest holders. Typically, in a drag-along provision, the majority interest holder, if it decides to sell its interest in the venture, can require the other partners to sell their interests to the buyer on the same terms. The **Tag-Along** strategy is a co-sale right that benefits minority shareholders.

In a tag-along provision, the minority partners have the option of requiring the selling partners to include their ownership interests in the sale on the same terms.

If the goal is to stop all but a total sale of interests in the venture, the tag-along provision achieves this goal. Internationally, specific performance may not be available to require a partner to include the interests of the other partners in a sale.

A final exit strategy is to end the joint venture through a **forced dissolution** or **forced sale**. In a forced dissolution, the partners have contractual rights to require the dissolution or liquidation of the joint venture for certain reasons. The most common reason that triggers the right to dissolution is a deadlock in the management of the venture. The forced sale is similar, but instead of having a right to dissolve the venture, the contract right requires the venture to be sold. The forced sale is the less drastic strategy and likely to be more profitable to partners than a forced dissolution.

Competition Law

The proliferation of international trade, FDI, and privatization has led to an increase in the importance of competition (antitrust) law. The existence of **competition law** and the proclivity of its enforcement vary depending on the level of economic development of the countries of concern. Countries with developed economies use competition law to combat anticompetitive activities, while developing countries see competition law as a means to eliminate barriers to attract foreign capital and investment and to spur economic growth. The result has been the passage of competition laws in many countries where they did not previously exist; however, enforcement is often minimal.¹⁴

Due to the constant innovations in the business world, competition law is constantly evolving. It is important for companies to be constantly alert to such changes when purchasing or merging with a foreign company, franchising, licensing, and in other company-to-company arrangements. The continuing evolution of competition law is also important to lesser-developed and emerging economies in order to continue to remain competitive in attracting foreign investment. Countries and companies need to stay abreast of changes in competition policies and best practices in enforcing or complying with competition law. A number of international organizations that study these issues include the International Competition Network (ICN), Organisation for Economic Co-operation and Development (OECD), and the United Nations Conference on Trade and Development (UNCTAD).

Chapter Summary

- 1 Just like the international trade of goods and services, the amount of foreign direct investment (FDI) has proliferated since the creation of the WTO in 1994, making national economies more interdependent.
- 2 The different types of FDI include Greenfield investments and portfolio investments. Greenfield investing involves the establishment of a business by starting up a new company in the host country or through mergers and acquisitions of existing companies in the host country. A number of other methods can also be employed to mitigate risks, such as a joint venture, alliances or syndicates, reciprocal distribution agreements, and franchising. Portfolio investments, or indirect foreign investment, consist of acquiring shares in a foreign company and ordinarily do not rise to the level of FDI. However, if the minority or passive foreign investor intercedes or collaborates with other investors to exert control over the management of the company, then that would constitute FDI.
- 3 The ability of a foreign country to attract FDI will depend on a number of factors, including size of economy, existence of natural resources, and the stability of the government and the macroeconomic environment. Investors are uncomfortable with uncertainty. The “Russian crisis” is used to show how a government through the decisions it makes can seriously disrupt the inward and outward flows of FDI, as well as the overall health of its economy. The factors that changed the flow of capital or FDI into Russia and weakened its economy included its invasion of the Ukraine in violation of international law; subsequent sanctions imposed by the EU and the United States; dramatic reduction in the prices of oil and gas (Russia’s biggest export product and

generator of revenues); and wasteful spending on the armed forces and the Olympics. These various factors, along with a high level of corruption, resulted in the economy going into recession, the collapse of the Russian currency (ruble), and high inflation. The argument that Russia was not at fault for the collapse of the oil and gas markets is a weak one. Russia failed to use the wealth generated from its past oil and gas revenues to restructure and diversify its economy and build much needed infrastructure. Its failure to do these things made its entire economy vulnerable to the fall in oil prices.

- 4 There are a number of risks associated with FDI including expropriation and nationalization. But expropriation is a rare occasion; instead the trend has been toward the privatization (selling) of government-owned industries and resources. The more relevant risk is that of creeping expropriation. In creeping or indirect expropriation the value of a foreign investment is reduced by increases and changes in host country regulations, such as increases in equity participation requirements (maximum percentage of foreign ownership); increases in local content requirements (minimum percentage of materials or component parts that need to come from the host country); export requirements (minimum required exports to insure inflow of money into host country); and capital and exchange controls (limiting the ability to exchange host country currency for hard currency and limiting the ability to repatriate hard currencies from the country).
- 5 FDI is not much more risky than domestic events due to a number of international and private law instruments. The WTO's Agreement on Trade-Related Investment Measures (TRIMs) provides basic protections for FDI that must be adhered to by WTO countries. Countries also insure the FDI of their citizens by entering bilateral investment treaties (BITs) with other countries. In large investments or projects, companies and investors may be able to negotiate a concession agreement with a foreign government that would insure certain rights and protections including protections against creeping expropriation. Companies also mitigate risks by entering joint ventures, alliances, and syndicates. The most common form is joint venturing with a domestic company of the host country in order to share the costs and lessen the risks of conforming to the foreign countries laws and regulations.
- 6 The most important development in FDI protections is the ability of an investor to bring a claim against a foreign government in arbitration instead of being forced to use the foreign government's own court system. The most common venue for investor-government arbitration is the International Centre for Settlement of Investment Disputes (ICSID). Most BITs require that disputes be arbitrated at the ICSID.
- 7 The U.S. Model BIT provides these basic FDI protections: fairness of treatment under the national treatment, most-favored-nation, and transparency principles; limiting the grounds for expropriation; prohibiting the use of performance requirements or local content requirements; free transferability of funds into and out of the host country; and the right of investors to submit an investment dispute to international arbitration. The American BIT also provides for environmental protection and workers' rights.
- 8 Another method that the foreign investor can use to shift risks is through franchising. In such a scenario, the investment costs are greatly diminished, as well as the risks of doing business with a foreign government. There are variations on franchising that should be considered, such as direct franchising, area development agreements, and master franchising.
- 9 In response to the proliferation of FDI, most countries have enacted competition (antitrust) laws. These laws may protect the foreign investors from unfair business practices of host country companies. At the same time, the investor must become aware of the requirements and restrictions of foreign competition law, especially in the case of mergers and acquisitions.

Key Terms

Agreement on Trade-Related Investment Measures (TRIMs)	Asia-Pacific Economic Cooperation (APEC)	Bilateral Investment Treaties (BITs)
Alternative Dispute Resolution (ADR)	Australian Tobacco Plain Packaging Act	BRIC Countries
Area Development Agreement	Bhopal Disaster	Competition Law
		Concession Agreement
		Covered Investments

Creeping Expropriation	Indirect Foreign Investment	Piggyback Marketing
Declaration on Fundamental Principles and Rights at Work	International Centre for Settlement of Investment Disputes (ICSID)	Portfolio Foreign Investment
Direct Investment Enterprise	Investment Claim	Proprietary Information
Disinvestment	Joint Venture	Reciprocal Distribution Agreements
Drag-Along Provision	Macroeconomic Stability	Right of First Offer
Equity Participation Requirements	Master Franchising	Right of First Refusal
Eurasian Economic Union	Minimum Standard of Treatment Principle	Russian Crisis
Expropriation	Model Bilateral Investment Treaty	Russian Roulette (Mexican Shoot-Out)
Fair and Equitable Treatment	Most-Favored-Nation Principle	Strategic Joint Venture
Forced Dissolution	National Treatment Principle	Syndicates
Forced Sale	Nationalization	Tag-Along Provision
Foreign Direct Investment (FDI)	New York Convention	Trade Claim
Franchising	Parallel Proceedings	Transparency Principle
Greenfield Investments (<i>De Novo</i> Investment)	Performance Requirements	Umbrella Clause
ICSID Additional Facility Rules		World Commodity Prices

Chapter Problems

- Why might a company consider investing abroad?
- In what respects is foreign direct investment riskier than the sale of goods (exporting)? What are the different means of minimizing those risks?
- What role do international institutions play in the protection of FDI?
- What are the differences between the following:
 - Greenfield investment
 - merger and acquisition
 - joint ventures
 What are the advantages of each of these forms of foreign direct investment? What are the unique concerns and issues for each form?
- Have foreign regulations of FDI become more or less restrictive over the last few decades? Why?
- In what ways can a company mitigate the risks of FDI?
- What legal standards must a host country meet in expropriating (nationalizing) a foreign investment?
- What is the importance of bilateral investment treaties (BITs) to a party considering FDI?
- What are the key issues in establishing and operating an international joint venture?
- How is international franchising different from purely domestic franchising? How is franchising different from licensing?
- What benefits does international franchising provide the franchisor and the franchisee?
- What factor should a franchisor consider in determining who, where, and how it should enter a franchise agreement?
- What types of provisions should a franchisor negotiate to protect itself?
- Explain the difference between:
 - area development agreement
 - direct franchising
 - master franchise agreement
 - subfranchisee

Internet Exercise

- Review the U.S. Model Bilateral Investment Treaty available at <http://www.state.gov/documents/organization/188371.pdf>.
- Review the website of the Asia-Pacific Economic Cooperation (APEC) to see the many different working groups, areas, and projects that it undertakes: <http://www.apec.org>.

Other Internet Sources

Global foreign investment trends: country investment guides, investment reviews, and analysis: www.oecd.org.

U.S. Department of Commerce: Web site contains a wealth of information on industrial trends and overseas investment statistics: www.doc.gov.

Foreign Commercial Service: country commercial analyses, partner identification program: www.usatrade.gov.

A joint venture between the **World Bank and WTO**, this site contains links to a wide range of country and regional reports, and information on local government agencies: www.itd.org.

Outline of the **financing and insurance programs** available for American firms investing overseas and a range of country and general information links for investors: www.opic.gov.

Notes

- 1 UN data at http://data.un.org/Data.aspx?d=WDI&f=Indicator_Code%3aBX.KLT.DINV.CD.WD (figures from World Bank).
- 2 The World Bank Group Rankings can be found at <http://www.doingbusiness.org/rankings>.
- 3 See generally, U.S. Commercial Service, *A Basic Guide to Exporting* (2015).
- 4 Kalman Kalotay, "The Impact of the New Ruble Crisis on Russian FDI," *Baltic Rim Economies—Bimonthly Economic Review* 31 (February 26, 2015)
- 5 Ibid. at 31–32.
- 6 Joost Pauwelyn, "Rational Design or Accidental Evolution? The Emergence of International Investment Law" in *The Foundations of International Investment Law* 27 (eds. Z. Douglas, J. Pauwelyn & J. Vinuales, Oxford University Press 2014).
- 7 ICSID Case No. ARB/87/13 (June 27, 1990).
- 8 R. Alford, "The Convergence of International Trade and Investment Arbitration," 12 *Santa Clara Journal of International Law* 35 (2014).
- 9 Ibid.
- 10 Ibid. at 48–50.
- 11 For an in-depth study of the issues related to umbrella clauses in BITs and information posed by the question in the textbox defining the umbrella clause, see Jarrod Wong, "Umbrella Clauses in Bilateral Investment Treaties," 14 *George Mason Law Review* 137 (2006).
- 12 See Larry A. DiMatteo, "Strategic Contracting: Contract Law as a Source of Competitive Advantage," 47 *American Business Law Journal* 727 (2010).
- 13 This section benefited from material provided by Andrew J. Markus, Carlton Fields, P.A., 100 SE 2nd Street, Suite 4000, Miami, Florida 33131.
- 14 H. Vedia Jerez, *Competition Law Enforcement and Compliance across the World: A Comparative Review* 389 (Wolters Kluwer 2015).

INTERNATIONAL E-COMMERCE

The growth of international Internet sales of goods, services, and digital content has been stunning. It has had a major impact in facilitating commercial (business-to-business or B2B) transactions, but has especially reshaped the marketplace for consumer sales (business-to-consumer or B2C), as well as personal transaction (person-to-person or P2P). Table 21.1 *Focus on Transactions*: “E-Commerce Consumer Sales Worldwide” shows the tremendous rate of growth of consumer sales via the Internet from 2012 to 2017. Currently, about 50 percent of all consumer sales are transacted over the Internet.

Internet marketing and sales transformation of the international marketplace has raised numerous regulatory issues because of its transborder nature and because the Internet is within the public domain. Thus, electronic commerce (e-commerce) poses a number of risks that have yet to be fully resolved. The scope of e-commerce issues is widespread and touches upon many different areas of business and law. An EU Council Resolution on the Consumer Dimension of the Information Society outlined the areas of concern for consumers and the conditions needed for e-commerce to thrive as follows: (1) accessibility and affordability; (2) transparency, including in quantity and quality of information; (3) fair marketing practices, offers, and contract terms; (4) protection of children against unsuitable content; (5) security of payment systems, including **electronic signatures**; (6) privacy and the protection of personal data; and (7) access to efficient systems of dispute resolution.

Despite the technological nature of the Internet, the same issues that are found in more traditional international business transactions apply to Internet transactions. For example, does an Internet transaction bring the seller within the scope of the laws and jurisdiction of the country of the buyer? Will the seller be liable for foreign income, sales, and value-added taxes? Is the transaction subject to foreign consumer protection laws? This chapter will survey a number of these issues including personal jurisdiction, protection of personal information, and content regulation. See Table 21.2 *Focus on Transactions*: “Legal Issues Relating to the Internet” for a list of the numerous legal issues that are posed by the Internet and e-commerce.

This chapter begins with a brief look at how questions of jurisdiction are being applied to electronic transactions. It then focuses directly on issues specific to e-commerce, such as trademark infringement, privacy, and database protection. After a brief introduction to electronic data interchange, an analysis of legal issues related to e-contracting is undertaken. The chapter concludes with the topic of e-commerce ethics.

Table 21.1 *Focus on Transactions*: E-Commerce Consumer Sales Worldwide¹ (Trillion Dollars)

Year	Sales	Percent Increase
2012	1.058	23.3
2013	1.251	18.3
2014	1.505	20.2
2015*	1.771	17.7
2016*	2.053	15.9
2017*	2.357	14.9

*Projections.

Table 21.2 Focus on Transactions: Legal Issues Relating to the Internet

<i>Issue</i>	<i>Area of Law</i>	<i>Solution</i>
Posting material that harms another's reputation (jurisdiction)	Tort law (defamation)	Long-arm statute
Liability of Internet service providers (ISPs) for digital content	Tort law (secondary or vicarious liability); Digital Millennium Copyright Act (DMCA)	ISPs have liability protection, but must disclose source of information and are liable if they fail to remove offensive material after being notified of its existence
Spam and other Internet abuses	Tort law (nuisance law)	Injunction
Misrepresentation	Tort-contract law	Use of disclaimers of not doing business in certain states or countries
Defective products and services (online sales)	Products liability and consumer protection laws	Litigation and government regulation (use of disclaimers of not doing business in certain states or countries)
Internet contracting	Contract formation	Uniform Electronic Transactions Act (UETA) Electronic agents
Online securities	Securities laws	Extraterritoriality; offshore exemption
Employee e-mails	Privacy law	No expectation of privacy; Canada's Personal Information Protection and Electronic Documents Act
Discovery of company and employee e-mails	Federal Rules of Civil Procedure	May subpoena employee's home computer for business-related evidence
Unauthorized downloading	Copyright and trademark law	Injunction
Domain names and metatags	Anti-cybersquatting law	Internet Corporation for Assigned Names and Numbers (ICANN)
Criminal and fraudulent activities	Criminal law	Encryption of data

Personal Jurisdiction

A key issue for the person making an initial foray into e-commerce is whether that person will become amenable to the jurisdiction of a foreign court. Does advertising or processing an order over the Internet provide enough contact with the jurisdiction of the other party to give a foreign court personal jurisdiction? Jurisdiction means the power of a court to hear a case. **Personal jurisdiction** pertains to the power or authority of a judge to require a defendant to defend herself in the judge's court. Under the Due Process Clause of the U.S. Constitution, a court gains personal jurisdiction over a defendant only if the defendant has had **minimum contacts** with the forum state.

A number of recent U.S. court decisions offer some guidance regarding personal jurisdiction in Internet transactions. A Federal Circuit Court in *Bensusan Restaurant Corp. v. King*² held that the creation of a web site did not constitute transacting business in a foreign jurisdiction. A restaurant operated under the same name as a trademarked nightclub in New York City. The trademark owner brought suit for tortious infringement of trademark in federal court in New York. The court held that the mere creation of a web site accessible in New York was not enough to prove sufficient intent to do business in New York. The case was dismissed for lack of personal jurisdiction.

Bensusan Restaurant Corp. v. King

126 F.3d 25 (2d Cir. 1997)

Van Graafeiland, Circuit Judge. Plaintiff, Bensusan Restaurant Corp., alleges in its complaint that it is the creator of an enormously successful jazz club in New

York City called The Blue Note, which name was registered as a federal trademark for cabaret services on May 14, 1985. Around 1993, a Bensusan representative wrote

to King demanding that he cease and desist from calling his club in Missouri The Blue Note. King, at the suggestion of a local web site design company, permitted that company to create a web site on the Internet for King's cabaret.

Bensusan then brought the instant action in the Southern District of New York, alleging violations of the Lanham Act and the Federal Trademark Dilution Act of 1995, as well as common law unfair competition. The web site described King's establishment as "Mid-Missouri's finest live entertainment venue located in beautiful Columbia, Missouri," and it contained the following text: The Blue Note's web site should not be confused with one of the world's finest jazz clubs, Blue Note, located in the heart of New York's Greenwich Village. Although we realize that attempting to apply established trademark law in the fast-developing world of the Internet is somewhat like trying to board a moving bus, we believe that well-established doctrines of personal jurisdiction law support the result reached by the district court.

New York law states in pertinent part that a New York court may exercise personal jurisdiction over a non-domiciliary who "in person or through an agent" commits a tortious act within the state. Even if Bensusan suffered injury in New York that does not establish a tortious act in the state of New York. Accordingly, in 1966 the New York Legislature enacted an amendment that provides in pertinent part that New York courts may exercise jurisdiction over

a non-domiciliary who commits a tortious act without the state, causing injury to person or property within the state. However, the exercise of jurisdiction is limited to persons who expect or should reasonably expect the tortious act to have consequences in the state and in addition derive substantial revenue from interstate commerce.

Because the alleged facts were not sufficient to establish that substantial revenues were derived from interstate commerce, a requirement that is intended to exclude non-domiciliaries whose business operations are of a local character, personal jurisdiction can not be determined. **AFFIRMED.**

Case Highlights

- The "minimum contacts" standard for establishing personal jurisdiction over a defendant must be applied to Internet activities.
- A long-arm statute grants jurisdiction where a tort (such as trademark infringement) that occurs outside the state causes injury inside the state.
- Mere creation of a web site containing trademark-infringing material does not satisfy the long-arm statute's requirements for personal jurisdiction.
- Personal jurisdiction does not attach to a tort committed outside of a state unless the defendant purposely directed its activities to the state and derived substantial revenue from those activities.

In the case of *Cybersell, Inc. v. Cybersell, Inc.*,³ a trademark owner brought suit for tortious infringement of trademark. A Florida company created a web page to advertise its web construction services. An Arizona company had a trademark for the same name. In dismissing the case, the court stated that: "no court has ever held that an Internet advertisement alone is sufficient to subject the advertiser to jurisdiction in another state." The court further emphasized that the Florida company had not contracted or sold to anyone in Arizona.

We turn now to a case on the opposite end of the jurisdictional spectrum from *Bensusan Restaurant Corp. v. King*: The *CompuServe, Inc. v. Patterson* case introduces the method of licensing software known as **shareware**. In that case, Patterson in effect used CompuServe as a distribution center to market his software. Because Patterson had chosen to transmit his product from Texas to CompuServe's system in Ohio, and because that system provided

CompuServe, Inc. v. Patterson

89 F.3d 1257 (6th Cir. 1996)

Brown, Circuit Judge. CompuServe is a computer information service headquartered in Columbus, Ohio. CompuServe operates as an electronic conduit to provide its subscribers computer software products, which may originate either from CompuServe itself or from other parties.

Computer software generated and distributed in this manner is, according to CompuServe, often referred to as "shareware." Shareware makes money only through the voluntary compliance of an "end user," that is, another CompuServe subscriber who pays the creator's suggested

licensing fee if she uses the software beyond a specified trial period. The “end user” pays that fee directly to CompuServe in Ohio, and CompuServe takes a 15 percent fee for its trouble before remitting the balance to the shareware’s creator.

Defendant Richard Patterson subscribed to CompuServe, and he had placed items of “shareware” on the CompuServe system for others to use and purchase. When he became a shareware “provider,” Patterson entered into a “Shareware Registration Agreement” (SRA). This Agreement expressly provides that both parties entered into the contract in Ohio, and that it is to “be governed by and construed in accordance with” Ohio law. From 1991 through 1994, Patterson electronically transmitted 32 master software files to CompuServe. Patterson’s software product was, apparently, a program designed to help people navigate their way around the larger Internet network. CompuServe began to market a similar product, however, with markings and names that Patterson took to be too similar to his own.

CompuServe filed this declaratory judgment action in the federal district court for the Southern District of Ohio. CompuServe sought, among other things, a declaration that it had not infringed any common law trademarks of Patterson. Patterson responded with a motion to dismiss for lack of personal jurisdiction.

The “purposeful availment” requirement is satisfied when the defendant’s contacts with the forum State “creates a ‘substantial connection’ with the forum State,” and when the defendant’s conduct and connection are such that he “should reasonably anticipate being haled into

court there.” Patterson chose to transmit his software from Texas to CompuServe’s system in Ohio, myriad others gained access to Patterson’s software via that system, and Patterson advertised and sold his product through that system. Moreover, this was a relationship intended to be ongoing in nature; it was not a “one-shot affair.”

Finally, because of the unique nature of this case, we deem it important to note what we do not hold. We need not and do not hold that Patterson would be subject to suit in any state where his software was purchased or used; that is not the case before us. We also do not have before us an attempt by another party from a third state to sue Patterson in Ohio for, say, a “computer virus” caused by his software; thus we need not address whether personal jurisdiction could be found on those facts. Finally, we need not and do not hold that CompuServe may sue any regular subscriber to its service for nonpayment in Ohio.

Because we believe that Patterson had sufficient contacts with Ohio to support the exercise of personal jurisdiction over him, we REVERSE the district court’s dismissal.

Case Highlights

- Shareware is a way of selling software where the user is permitted to download and use that software for a trial period, after which the user is asked to pay a fee to the author for continued use.
- Due process considerations for purposes of personal jurisdiction are satisfied if the defendant “purposely avails” itself to the laws of the forum state.

access to his product to others to whom he advertised and sold his product, the court concluded that Patterson purposefully availed himself of the privilege of doing business in Ohio.

By contrast, the *Bensusan* case involved the use of a *passive web site*. The court observed that whereas the Internet user in *CompuServe* specifically targeted Ohio by entering into an agreement to sell his software over the Internet to out-of-state purchasers, mere advertising on a passive web site does not subject one to the jurisdiction of another state’s courts.

The *Zippo Manufacturing Co. v. Zippo Dot Com, Inc.*⁴ case that follows established a sliding-scale approach to the establishment of personal jurisdiction for Internet activities. In that case, the defendant’s web advertisement was followed by the sale of services to more than 3,000 subscribers in the state of Pennsylvania. The number of contacts and sales within a given state is likely to be considered the major factor in the personal jurisdiction decision.

Zippo Manufacturing Co. v. Zippo Dot Com, Inc.

952 F. Supp. 1119 (W.D. Pa. 1997)

McLaughlin, District Judge. This is an Internet domain name dispute. Domain names serve as a primary identifier of an Internet user. Internet companies commonly use their

business names as part of their domain names (e.g., IBM.com). The designation “.com” identifies the user as a commercial entity. We must decide the Constitutionally

permissible reach of Pennsylvania's Long-Arm Statute through cyberspace. Zippo Manufacturing Corporation ("Manufacturing") has filed a complaint against Zippo Dot Com, Inc. ("Dot Com"), alleging trademark dilution, infringement, and false designation under the Federal Trademark Act. Dot Com has moved to dismiss for lack of personal jurisdiction.

Manufacturing is a Pennsylvania corporation with its principal place of business in Bradford, Pennsylvania. Manufacturing makes, among other things, the well-known "Zippo" tobacco lighters. Dot Com is a California corporation with its principal place of business in Sunnyvale, California. Dot Com operates an Internet web site and an Internet news service and has obtained the exclusive right to use the domain names "zippo.com," "zippo.net" and "zipponews.com" on the Internet. A "site" is an Internet address that permits the exchange of information with a host computer. The "web" or "World Wide Web" refers to the collection of sites available on the Internet. Dot Com has registered these domain names with Network Solutions, Inc., which has contracted with the National Science Foundation to provide registration services for Internet domain names. Once a domain name is registered to one user, it may not be used by another.

Dot Com's contacts with Pennsylvania have occurred almost exclusively over the Internet. Dot Com's offices, employees, and Internet servers are located in California. Dot Com maintains no offices, employees, or agents in Pennsylvania. Dot Com's advertising for its service to Pennsylvania residents involves posting information about its service on its web page, which is accessible to Pennsylvania residents via the Internet. Defendant has approximately 140,000 paying subscribers worldwide. Approximately 2 percent (3,000) of those subscribers are Pennsylvania residents.

Personal Jurisdiction

Our authority to exercise personal jurisdiction in this case is conferred by state law. The Due Process Clause of the Fourteenth Amendment to the Federal Constitution governs the extent to which a court may exercise that authority. Pennsylvania's long arm jurisdiction statute permits the exercise of jurisdiction over nonresident defendants upon: "Contracting to supply services or things in this Commonwealth." General jurisdiction permits a court to exercise personal jurisdiction over a nonresident defendant for non-forum related activities when the defendant has engaged in "systematic and continuous" activities in the forum state.

In the absence of general jurisdiction, specific jurisdiction permits a court to exercise personal jurisdiction over a

nonresident defendant for forum-related activities, where the "relationship between the defendant and the forum falls within the 'minimum contacts' framework." A three-pronged test has emerged for determining whether the exercise of specific personal jurisdiction over a nonresident defendant is appropriate: (1) the defendant must have sufficient "minimum contacts" with the forum state, (2) the claim asserted against the defendant must arise out of those contacts, and (3) the exercise of jurisdiction must be reasonable.

Internet and Jurisdiction

The Supreme Court noted that "as technological progress has increased the flow of commerce between States, the need for jurisdiction has undergone a similar increase." Enter the Internet, a global "super-network" of over 15,000 computer networks used by millions of individuals, corporations, organizations, and educational institutions worldwide." With this global revolution looming on the horizon, the development of the law concerning the permissible scope of personal jurisdiction based on Internet use is in its infant stages. The likelihood that personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of commercial activity that an entity conducts over the Internet.

At one end of the spectrum are situations where a defendant clearly does business over the Internet. If the defendant enters into contracts with residents of a foreign jurisdiction that involves the knowing and repeated transmission of computer files over the Internet, personal jurisdiction is proper.

At the opposite end are situations where a defendant has simply posted information on an Internet web site that is accessible to users in foreign jurisdictions. A passive web site that does little more than make information available to those who are interested in it is not grounds for the exercise of personal jurisdiction.

Interactive web sites where a user can exchange information with a host computer occupy the middle ground. In these cases, the exercise of jurisdiction is determined by examining the level of interactivity and commercial nature of the exchange of information that occurs on the web site.

Application to this Case

First, we must note that this is not an Internet advertising case. Dot Com has not just posted information on a web site that is accessible to Pennsylvania residents connected to the Internet. This is not even an interactivity case, since Dot Com has done more than create an interactive web site through which it exchanges information with Pennsylvania

residents in hopes of using that information for commercial gain later. We are not being asked to determine whether Dot Com's web site alone constitutes the purposeful availment of doing business in Pennsylvania. We are being asked to determine whether Dot Com's conducting of electronic commerce with Pennsylvania residents constitutes the purposeful availment of doing business in Pennsylvania.

We conclude that it does. Dot Com has contracted with approximately 3,000 individuals and seven Internet access providers in Pennsylvania. The intended object of these transactions has been the downloading of the electronic messages that form the basis of this suit in Pennsylvania. We conclude that this Court may appropriately exercise personal jurisdiction over the Defendant and that venue is proper in this judicial district.

Case Highlights

- A sliding scale is used to determine if an Internet activity is sufficient to qualify as "minimum contacts" for purposes of attaching personal jurisdiction to a defendant.
- A company that clearly does business over the Internet is amenable to the personal jurisdiction of a foreign state in which it transacts business.
- A person or company that merely maintains a "passive" web site is not subject to the jurisdiction of a foreign court.
- Personal jurisdiction based upon an interactive web site will depend on the level of interactivity and the commercial nature of the site.

In order to avoid being amenable to suit in a given jurisdiction, it is advisable to place clear **disclaimers** within a web site that your intent is not to engage in transactions with residents in that jurisdiction.

The Figure 21.1 *Comparative Law*: "EU Regulation on Jurisdiction, Recognition, and Enforcement of Judgments" offers excerpts from an EU regulation that requires an Internet retailer to defend itself in the courts of a consumer located in a EU country. This statutory intervention would make the minimum contacts analysis required in the United States, as used in the *Zippo*, *CompuServe*, and *Bensusan* cases, irrelevant. EU regulations also void the forum selection clause of a license or web page.

The proposed EU regulation brings up a crucial issue of whether a court's exercise of personal jurisdiction over a foreign defendant will be recognized and enforced by a foreign court system. A winning plaintiff in international litigation will often be forced to seek execution of the judgment in a foreign court system. A defendant may not pay

EU Regulation on Jurisdiction, Recognition, and Enforcement of Judgments

Jurisdiction over Consumer Contracts

In matters relating to a contract concluded by a person, the consumer, for a purpose which can be regarded as being outside his trade or profession, jurisdiction shall be determined by this Section, if: (1) it is a contract for the sale of goods on installment credit terms; (2) it is a contract for a loan repayable by installments, or for any other form of credit, made to finance the sale of goods; or (3) in all other cases, the contract has been concluded with a person who pursues commercial or professional activities in the Member State of the consumer's domicile or, by any means, directs such activities to that Member State or to several countries including that Member State, and the contract falls within the scope of such activities.

Article 16

A consumer may bring proceedings against the other party to a contract either in the courts of the Member State in which that party is domiciled or in the courts for the place where the consumer is domiciled. Proceedings may be brought against a

consumer by the other party to the contract only in the courts of the Member State in which the consumer is domiciled.

Jurisdiction over Individual Contracts of Employment Article 18

Where an employee enters into an individual contract of employment with an employer who is not domiciled in a Member State but has a branch, agency, or other establishment in one of the Member States, the employer shall, in disputes arising out of the operations of the branch, agency, or establishment, be deemed to be domiciled in that Member State.

Article 20

An employer may bring proceedings only in the courts of the Member State in which the employee is domiciled. The provisions of this Section shall not affect the right to bring a counterclaim in the court in which, in accordance with this Section, the original claim is pending.

Figure 21.1 *Comparative Law*: EU Regulation on Jurisdiction, Recognition, and Enforcement of Judgments.

Braintech, Inc. v. Kostiuk***British Columbia Court of Appeals (1999)***

Goldie, Justice. The Plaintiff was a technology company incorporated in Nevada and doing business in various United States jurisdictions. It brought an action in Texas against a resident of British Columbia, alleging the Defendant had published defamatory information about the corporation on an Internet bulletin board. The Texas Civil Code deems a nonresident to do business in the jurisdiction if it commits a tort there.

The Plaintiff obtained a default judgment in Texas and commenced an action on that judgment in British Columbia. British Columbia is obligated to recognize foreign judgments according to principles of reciprocity and comity. However, there is a constitutional limitation in the United States on the exercise of personal jurisdiction that requires the Defendant to have sufficient minimum contacts with the jurisdiction. Furthermore, the court must consider whether there was a “real and substantial” connection to Texas. The Defendant’s only connection to Texas was passive posting on an Internet bulletin board. To enforce recovery of the default judgment would encourage a multiplicity of actions wherever the Internet is available.

The issue in this case is whether there was a real and substantial connection between Texas and the wrongdoing

alleged to have taken place. In my opinion, the trial judge erred in failing to consider whether there were any contacts between the Texas court and the parties which could, with the Due Process Clause of the Fourteenth Amendment to the Constitution of the United States, amount to a real and substantial presence. In the circumstances revealed by the record before this Court, British Columbia is the only natural forum and Texas is not an appropriate forum. Comity does not require that the courts of this province recognize the default judgment in question. DISMISSED.

Case Highlights

- One country is obligated under international law (principle of comity) to recognize the judicial judgments of a foreign court.
- This recognition is not required unless the exercise of personal jurisdiction satisfies the requirements of due process.
- The passive posting of a defamatory statement on an Internet bulletin board does not establish a “real and substantial” connection with a foreign state for purposes of personal jurisdiction.

on the judgment voluntarily. In such a case, the judgment holder will have to obtain satisfaction of the judgment by taking the assets of the defendant. In order to do this he will have to gain the cooperation of a foreign court.

Under the international law principle of *comity*, countries are expected to honor the judicial judgments and orders of a foreign court. However, as discussed in Chapter 4, this recognition is sometimes denied. The *Braintech, Inc. v. Kostiuk* case demonstrates that even closely aligned legal systems, such as those of the United States and Canada, will not enforce the judgment of the other if they determine that the exercise of personal jurisdiction was improper. The case is an issue of first instance involving the posting of defamatory information on an Internet bulletin board.

Trademark Infringement and Dilution

Trademark protection is “the law’s recognition of the psychological function of symbols.” Two goals of trademark law are reflected in the federal scheme. On the one hand, the law seeks to protect consumers who have formed particular associations with a mark. On the other hand, trademark law seeks to protect the investment in a mark made by the owner. A recurring problem in Internet commerce has been the misappropriation of names by so-called *cybersquatters*. Cybersquatters are parties that register a famous brand name or trademark as their Internet domain name. The cybersquatter then attempts to extort a payment from the trademark owner for its registered domain name.

The two statutory recourses available in the U.S. to the trademark owner are the **Lanham Act**⁵ and the **Federal Trademark Dilution Act of 1995**.⁶ The Lanham Act requires a likelihood of confusion between the junior user’s (infringing party) and the senior user’s products. Courts have held that when the goods or services are unrelated

to the trademark owner's products, such as when the domain name is registered on behalf of no particular product or service, there is no likelihood of confusion. The Federal Trademark Dilution Act, however, does not require proof of a likelihood of confusion.

Courts have held that the registering of a domain name for the purpose of selling it to a trademark owner is actionable under the Dilution Act. This was confirmed in *Avery Dennison Corp. v. Sumpton*,⁷ where the court labeled the defendant a cybersquatter. The court concluded that the defendant's use diluted the well-known trademark of the plaintiffs. In holding against the defendant, the court noted that it had registered more than 12,000 domain names.

Unlike infringement and unfair competition laws, in a dilution case competition between the parties and a likelihood of confusion are not required to present a claim for relief. Rather, injunctive relief is available under the Federal Trademark Dilution Act if a plaintiff can establish that (1) its mark is famous; (2) the defendant is making commercial use of the mark in commerce; (3) the defendant's use began after the plaintiff's mark became famous; and (4) the defendant's use presents a likelihood of dilution of the distinctive value of the mark.

In *Panavision Int'l, L.P. v. Toeppen*⁸ it was held that the Federal Trademark Dilution Act was implicated when the defendant registered domain-name combinations using famous trademarks and sought to sell the registrations to the trademark owners. Commercial use under the Federal Trademark Dilution Act requires the defendant to be using the trademark as a trademark, capitalizing on its trademark status. In this classic "cybersquatter" case, the court determined that the infringer's intent was to "arbitrage" the registration that included the plaintiff's trademark.

As discussed in Chapter 13, **blurring** is a type of trademark dilution where it is unlikely that consumers will mistake the two companies' products because the products may be dissimilar. Nonetheless, the dilutor's use of the mark still may dilute the uniqueness of the more famous mark. The court in *Toys "R" Us v. Feinberg*⁹ held that a gun company's use of the domain name "gunsareus" neither infringed nor diluted the senior mark. The court held that any blurring was tenuous because the average consumer would not connect the two names or marks. It confirmed nonetheless that dilution is applicable to Internet cases.

In 1999, Congress enacted the **Anti-Cybersquatting Consumer Protection Act (ACPA)**. The *Mattel, Inc. v. Internet Dimensions* case was one of the first cases to apply the ACPA. It is important to note that three types of claims can be made under federal law: trademark infringement, trademark dilution, and violation of ACPA.

Mattel, Inc. v. Internet Dimensions, Inc.

2000 U.S. Dist. LEXIS 9747 (S.D.N.Y. 2000)

Baer, District Judge. Plaintiff Mattel, Inc. ("Mattel"), commenced this action against defendants Internet Dimensions, Inc. ("Internet Dimensions"), and Benjamin Schiff asserting causes of action for (1) trademark infringement under Section 43(a) of the Lanham Act, (2) trademark dilution under Section 43(c) of the Lanham Act, and (3) violation of the Anti-Cybersquatting Consumer Protection Act of 1999 ("ACPA" or "the Act"). Mattel is a publicly held corporation organized and existing under the laws of the State of Delaware. One of its principal products is the trademarked "Barbie" doll.

In 1991, the Second Circuit observed that "the 'Barbie' doll is the best selling toy doll in the world—96 percent of three- to eleven-year-old girls in the United States own at least one. In the past 30 years 600 million Barbie dolls

have been sold—one is sold every two seconds—and, in 1990 alone, 26 million of them were sold, earning gross revenues for Mattel of \$740 million."

Internet Dimensions is a corporation organized and existing under the laws of the State of Nevada. Internet Dimensions owns Internet domain names for sites that provide, among other things, "adult" entertainment. One of its domain names is "barbiesplaypen.com."

Mattel's primary claim in this action is that defendants violated the Anti-Cybersquatting Consumer Protection Act. The ACPA, signed into law on November 29, 1999, provides that "a court may order the forfeiture or cancellation of the domain name or the transfer of the domain name to the owner of the mark." It also provides that damages can be awarded for violations of the Act.

The ACPA was passed to “protect consumers and American businesses, to promote the growth of online commerce, and to provide clarity in the law for trademark owners, by prohibiting the bad-faith and abusive registration of distinctive marks as Internet domain names with the intent to profit from the goodwill associated with such marks—a practice commonly referred to as ‘cybersquatting.’” The Act provides civil liability for cybersquatting as follows:

A person shall be liable in a civil action by the owner of a mark if that person (i) has a bad faith intent to profit from that mark and (ii) registers, traffics in, or uses a domain name that: (1) is identical or confusingly similar to a mark that is distinctive at the time of registration of the domain; (2) in the case of a famous mark that is famous at the time of registration of the domain name, is identical or confusingly similar to or dilutive of that mark; (3) is a trademark, word, or name.

While there is no particular inherent distinctiveness in the name “Barbie,” the mark, as it applies to Mattel, has acquired distinctiveness through four decades of exposure in the American consumer market. The Court concludes that the name “Barbie” and the font normally used to advertise BARBIE products is widely recognized throughout the world on the basis of the marketing efforts that have been undertaken by Mattel over the past four decades. The Court finds that the trademark BARBIE is both “distinctive” and “famous” for purposes of § 1125(d).

The next question is whether the domain name “barbiesplaypen.com” is “identical or confusingly similar to” the BARBIE mark. The similarities between “barbiesplaypen.com” and the BARBIE trademark are as follows: (1) both contain the name “barbie;” (2) the name “Barbie” on the front page of the web site and the logo BARBIE both have approximately the same font, slant, size, etc.; (3) both BARBIE and “barbiesplaypen.com” are inextricably associated with the verb “play,” in the broad sense of the term. All of the above similarities make the web site “barbiesplaypen.com,” and its domain name, “confusingly similar,” though not “identical” to the BARBIE mark.

I next turn to the issue of whether the defendants registered, used, or trafficked in the domain name “barbiesplaypen.com” with a “bad faith intent to profit” from the Barbie mark. We find that the defendants did engage in a “bad faith attempt to profit” from the BARBIE trademark by maintaining the infringing domain name and web site. It is clear that the defendants expected the same advertising result as Mattel from the use of the domain name “barbiesplaypen.com.” The defendants must have expected that consumers searching under the word BARBIE, or perhaps the words “BARBIE and PLAY,” in an Internet search engine would be directed to defendants’ pornographic “barbiesplaypen.com” site. The diversion of Internet users to a site containing pornographic images may well *tarnish* the image of Mattel’s BARBIE products in the minds of those consumers.

Under the ACPA, Mattel is entitled to an order directing defendants to transfer the registration of the domain name “barbiesplaypen.com” to Mattel. This Court finds that a permanent injunction barring defendants from the commercial use and infringement of any of Mattel’s BARBIE trademarks is also warranted. Finally, the plaintiff is also entitled to statutory damages and attorneys’ fees. SO ORDERED.

Case Highlights

- A party can be liable for trademark infringement even if it sells a product dissimilar to the products sold by the trademark owner. For example, if the infringing use of the trademark “tarnishes” the image of the trademark owner, then the user is guilty of trademark dilution.
- Domain names serve to identify the Internet user. Therefore, businesses prefer to use their trade names as part of their domain names.
- Cybersquatting is the bad faith registration of distinctive trademarks as Internet domain names.
- The Anti-Cybersquatting Consumer Protection Act (ACPA) protects trademark owners from the bad faith use of their trade name by others who register infringing domain names.

Section 1125(c)(1) of the Trademark Act provides the following factors in determining whether a mark is distinctive and famous: (1) degree of inherent or acquired distinctiveness of the mark; (2) duration and extent of use of the mark in connection with the goods or services with which the mark is used; (3) the duration and extent of advertising and publicity of the mark; (4) geographical extent of the trading area in which the mark is used; (5) channels of trade for the goods or services with which the mark is used; (6) degree of recognition of the mark in the trading areas and channels of trade used by the mark’s owner and the person against whom the injunction is sought; and (7) the nature and extent of use of the same or similar marks by third parties.

Internet Privacy and Database Protection

Justice Brandeis once stated that: “the right to be left alone is the most comprehensive of rights, and the most valued by civilized persons.”¹⁰ The problem of Internet privacy involves the need to balance the individual’s right to privacy with the right to develop, transfer, and sell databases compiled with personal data. One issue is the ability of one company to sell its customers list to another company. In this instance, information that an individual believes to be submitted confidentially to one party can end up being used by other parties for different purposes.

In a recent case, the Federal Trade Commission brought suit against Toysmart.com, which had filed for bankruptcy protection, to prevent it from selling its list of 250,000 customer names, addresses, and credit card numbers in order to satisfy its debts. The proposed sale contradicted the e-company’s own assurances to its customers that their registered information would “never be shared with a third party.” A settlement was reached that allowed Toysmart.com to sell its list under a number of conditions. First, the list could only be sold as part of a package that included the entire web site. Second, it could only be sold to a qualified buyer in a related market. Third, the buyer must agree to abide by the web site’s privacy policy. If a qualified buyer is not found, then Toysmart.com must destroy the customer information.

The United States and the EU have elected two different approaches to this problem, not surprising since ingrained cultural attitudes about personal privacy separate the United States from many of the European countries. Europeans are more restrictive in regulating the way companies collect and process personal data. The EU has enacted comprehensive legislation to deal with personal privacy on the Internet. In contrast, the United States has not enacted data protection legislation, instead electing to allow the Internet industry to self-regulate.

Many of today’s most popular web sites serve as data collection instruments. Personal information given by a visitor to a web site is collected for future use, sometimes covertly through the use of *cookies* or tags. Cookies are used to identify visitors to a web site. They allow the web site to obtain the visitor’s e-mail address, name, the specific pages of the web site that were visited, and what electronic transactions were made. This personal information can then be used for future marketing purposes or sold to others by the web site owners.

Although the United States does not have a comprehensive Internet privacy law, a number of existing statutes offer some protections. The federal statutes focus upon specific industries. For example, the **Fair Credit Reporting Act**¹¹ governs the use of data by the credit reporting industry. The **Privacy Act of 1994** restricts government agencies from releasing personal information found in its documents and records. The **Telephone Consumer Protection Act**¹² is directed at the abuse of telemarketing activities through telephone solicitations. This Act may be applicable to bulk e-mail solicitations known as **spamming**.¹³

The **Electronic Communications Privacy Act of 1986**¹⁴ extends federal wiretap requirements to new forms of electronic communications such as e-mail and applies to service providers engaged in the transmission and storage of electronic communications. It does not prevent the recipient of the communication from disclosing the contents to others. The **Telecommunications Act of 1996**¹⁵ restricts the disclosure by telecommunications companies of information about subscribers’ use of their services.

The European Union enacted the **Directive 95/46** on the Protection of Individuals with Regard to the Processing of Personal Data and the Free Movement of Such Data and, subsequently, **Directive 2002/58/EC** “concerning the processing of personal data and the protection of privacy in the *electronic* communications.” The later Directive mainly extends the older privacy Directive to electronic communications and databases. See Figure 21.2 *Comparative Law*: “EU Directive 2002/58/EC on Data Privacy.” Directive 95/46 proscribes the following standards of data quality: (1) personal data must be processed fairly and lawfully; (2) personal data must be “collected for specific, explicit, and legitimate purposes and not further processed in a way incompatible with those purposes”; (3) personal data must be “accurate and kept up to date”; (4) every reasonable step must be taken to ensure that data which are inaccurate or incomplete are erased or rectified; and (5) personal data that permits identification of the subject should be kept “no longer than is necessary for the purposes for which the data was collected.”

Directive 2002/58 applies to intra-EU and international transfers and use of personal data. Article 25 of the Directive prohibits the transfer of data to countries outside the EU unless the countries' laws provide "adequate" privacy protections. U.S. companies must comply with the Directive to do business in the EU. The Directive places severe restrictions on companies' processing and use of personal data. First, a company must get the express consent of the individual in order to collect and use personal data. "Personal data" is broadly defined to mean almost any

information even indirectly related to an individual. Second, data processors must make detailed disclosures to EU authorities about their data collection activities. Third, the foreign companies must show that they provide similar privacy protections as found in the EU Directive. Fortunately, this has not been a major obstacle due to a **safe harbor agreement** between the EU and the U.S. Under the agreement, an American company need only join a self-regulatory privacy program or create its own privacy program.

Figure 21.2 Comparative Law: EU Directive 2002/58/EC on Data Privacy.

Directive 95/46 grants the data subject a number of rights. First, every subject has a **right of access** to obtain "confirmation as to whether data relating to him are processed and as to the purposes of the processing, the categories of data being processed, and the recipients to whom the data are disclosed." Second, a **blocking right** and **right of correction** are granted whereby the subject has the right to "the rectification, erasure, or blocking of data, the processing of which does not comply with this Directive, in particular because of the incomplete or inaccurate nature of the data." Third, there is a limited **right of objection** "on compelling legitimate grounds" to a particular processing of data relating to him.

In addition, Article 25 of the Directive prohibits the transfer of data outside the EU to a third country that does not provide an adequate level of protection. Therefore, the Directive prohibits the transfer of data to the United States and other non-EU countries not meeting EU standards for the protection of personal privacy. Such transfers are permissible, however, even if a third country lacks adequate controls if the subject consents to the transfer or if the transfer is necessary for the performance of a contract between the subject and the data possessor. Article 25 offers the possibility of a severe interruption of data flows from Europe to the United States because the United States has not enacted "adequate" data.

Initially, the EU continued to permit U.S. companies to export personal data from Europe and entered into negotiations in order to avert a trade war. In 2000, the United States and the EU completed negotiations on the **safe harbor agreement**. This accord allows for privacy protection that is deemed adequate, but not equivalent to that under EU law. If U.S. companies comply voluntarily, they will be given *safe harbor* from lawsuits by EU countries. A controversial part of the safe harbor principles is that a company can self-certify by filing a letter annually with the Department of Commerce. The certification can be performed through self-assessment or outside review. Any self-assessment should state the company's privacy policy, along with confirming the existence of procedures for conducting periodic reviews, for training employees, and for disciplining violations. The only specific sanction for misrepresentations in the self-certification letter is by way of an action by the Federal Trade Commission.

Unlike the U.S., the EU has enacted comprehensive laws dealing with the protection and use of databases. **Directive 96/9/EC on the Legal Protection of Databases** defines the term *database* as "literary, artistic, musical, or other collections of works or collections of other material such as texts, sound, images, numbers, facts, and data systematically or methodically arranged and that can be individually accessed." The EU has also enacted a directive to grant special protection to databases that are a product of "considerable investment of human, technical, and financial resources" (see Figure 21.3 *Comparative Law*: "Directive 96/9/EC: Legal Protection of Databases"). If a database is a product of such investment, then the Directive grants its creator or owner a 15-year term of protection.

U.S. law, in contrast, does not protect databases other than by prohibiting the verbatim copying of databases under copyright law. An alternative means of protecting a database in the U.S. is through trade secrets law. However, it is difficult to maintain a database or customers list as a trade secret if it is accessible by a large pool of employees. It is strategically prudent for U.S. companies to review Directive 96/9/EC in order to obtain the Directive's protection for its European operations.

<ol style="list-style-type: none"> 1 The making of databases requires the investment of considerable human, technical, and financial resources while such databases can be copied or accessed at a fraction of the cost needed to design them independently; 2 This Directive protects collections, sometimes called <i>compilations</i>, of works, data, or other materials, which are arranged, stored, and accessed by means which include electronic processes; 3 No criterion other than originality, in the sense of the author's intellectual creation, should be applied to determine the eligibility of the database for copyright protection, and in particular no aesthetic or qualitative criteria should be applied; 4 Works protected by copyright and subject matter protected by related rights that are incorporated into a database remain, nevertheless, protected by the respective exclusive rights and may not be incorporated into, or extracted from, the database without the permission of the right holder or his successors in title; 	<p style="text-align: center;">Article 3: Object of Protection</p> <ol style="list-style-type: none"> 1 In accordance with this Directive, databases, which by reason of the selection or arrangement of their contents constitute the author's own intellectual creation, shall be protected as such by copyright. 2 The copyright protection of databases provided for by this Directive shall not extend to their contents and shall be without prejudice to any rights subsisting in those contents themselves. <p style="text-align: center;">Article 10: Term of Protection</p> <p>The right provided for in this Directive shall run from the date of completion of the making of the database and shall expire 15 years from the first of January of the year following the date of completion.</p>
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Figure 21.3 *Comparative Law*: Directive 96/9/EC: Legal Protection of Databases.

E-Commerce and E-Contracting

Doing business on the Internet has become so commonplace that traditional “brick-and-mortar” retail stores have had to aggressively go online or suffer diminished sales. There are three basic types of commercial web sites: informational, transactional, and e-marketplaces. *Informational web sites* generate sales by promoting corporate awareness rather than facilitating online transactions. They function much like a brochure that provides information about the product or service and gives contact information needed to proceed with a purchase. **Transactional web sites** are electronic storefronts for brick-and-mortar retailers or catalog businesses, or act as showrooms for manufacturers to sell directly to the public. Transactional web sites conduct full “end-to-end” transactions through the web site, allowing customers to search for, order, and pay for products online, and obtain after-sales services. The more sophisticated web sites integrate online sales with internal systems such as accounting, inventory, service, and sales.

E-Marketplace web sites bring buyers and sellers together to facilitate transactions. Participation in a brokerage-style web site provides the ability to obtain customers and at the same time avoid the costs of building a proprietary transactional web site. Types of brokerages include auctions, virtual malls, and matching services. Popular third-party marketplaces or platforms include eBay, Amazon, and Alibaba. These platforms have excelled in fast processing and delivery of orders. They are price competitive because they make bulk purchases from suppliers and arrange logistics themselves.

The first generation of electronic contracting was performed through the use of **electronic data interchange (EDI)**. EDI is the computer-to-computer communication of information. The use of EDI for purposes of forming contracts will continue to grow. For example, in the documentary transaction, contracts will be electronically formed, electronic bills of lading will be sent to a third-party record-keeping service, letters of credit will be issued based upon preexisting templates, and other necessary documents like insurance certificates will be requested and transmitted by computers. The closed nature of the EDI system allows private parties to create their own law to fill the void created by a lack of legislation.

The rules governing EDI transactions are provided in contracts known as **trading partner agreements** or interchange agreements. This form of contracting makes sense only when one contemplates a long-term contractual relationship with a relatively modest number of contracting parties. (This is in contrast to Internet commerce that often includes many one-time transactions with relatively unknown purchasers and sellers.) The American Bar Association has developed a **Model Electronic Data Interchange Trading Partner Agreement**¹⁶ that can be tailored to particular types of transactions.

E-Contracting Law Issues

The open nature of the Internet calls for a more proactive government regulation. A legal framework needs to be built to ensure the security and integrity of open network (Internet) transactions. The three major concerns for international electronic contracting are authenticity, enforceability, and confidentiality. Authenticity involves the verification of the identity of the party one is dealing with electronically. Enforceability includes the legal scope of the license granted or the warranty given under a national law. It also includes the provability and verification of the contractual terms of an online transaction.

Confidentiality revolves around the protection of sensitive information such as payment information and trade secrets. The fear is that the public nature of e-commerce makes such information susceptible to fraud and misappropriation by third parties. The minimum level of due diligence pertaining to these three concerns demands a workable knowledge of the legal requirements of forming and proving a contract through the Internet.

Electronic contracting poses a number of questions about the application of contract law to this new medium for transacting business. For example, what communications are considered offers and acceptances? When and where does an electronic acceptance reach the offeror? The answers depend on the type of communications and information being provided. A noninteractive web page is more like an advertisement or an invitation to make an offer. Conversely, an interactive web page designed to accept payment information such as credit card numbers could be construed as a standing offer.

The use of e-mail to negotiate contracts opens up the offeror to an acceptance by e-mail. Does the acceptance reach the offeror upon receipt by the service provider and placement in the offeror's mailbox or when the offeror opens his mailbox? The better answer would seem to be the former, because the offeror is inviting acceptance by e-mail and is thus under an implied duty to retrieve his mail in a timely fashion. The next section will review a model law that attempts to provide answers to these and other formation questions.

Uniform Computer Information Transactions Act

Uniform Computer Information Transactions Act (UCITA) is a model law enacted to cover the creation, transfer, and licensing of computer information and software. UCITA provides rules for sales of software and the licensing of information. A *license* is a contract that grants a licensee limited use of the intellectual and informational property rights of the licensor. The licensor retains ownership of the rights being licensed. Generally, the licensee obtains a right to use a particular copy of the licensor's property.

The formation of a contract under UCITA depends on the receipt of the acceptance by the offeror. This is opposite to the common law's acceptance-upon-dispatch or mailbox rule. Receipt of an electronic notice is defined as "coming into existence in an information processing system or at an address in that system in a form capable of being processed by or perceived from a system of that type by a recipient, if the recipient uses, or otherwise has designated or holds out, that place or system for receipt of notices." Thus, a contract is formed even if the receiving party fails to open or read the message of acceptance. UCITA provides the following rules: (1) downloading of information or *clicking* approval to terms constitute acceptances; (2) additional terms found in the shrink-wrapped license do become a part of the contract if the purchaser or licensee is able to review them prior to being obligated to pay. After reviewing the license, the purchaser has a right to return the item for a full refund; (3) **electronic agents**, such as a computer or voice ordering system can form contracts through the interaction of electronic agents and by the interaction of an electronic agent and an individual. The contract is formed if the individual takes actions or makes statements that he knows will cause the electronic agent to perform. Additional terms incorporated into the acceptance by the individual do not become a part of the contract if the individual "had reason to know that the electronic agent could not react to the inclusion of additional terms."

UCITA provisions deal directly with software licenses that grant the licensee the right to access information of the licensor. This type of license is referred to as an **access contract**.

A contract is formed only when a person has an opportunity to review the terms of the contract. A party's "opportunity to review" the terms of a contract only after paying or beginning performance (as in a shrink-wrap

contract) does not form a contract on those terms unless the party has a right to return. A licensor that makes information available by electronic means from its Internet site must give the licensee an opportunity to review the terms of the license (click-wrap contract). The opportunity to review requirement is satisfied if the licensor makes a reference to an electronic location prominently and in close proximity to a description of the information or by disclosing the availability of the terms in a prominent place on the site.

Shrink-Wrap Contracts

Computer software is generally sold encased in plastic wrappers. Inside the wrapper are the terms, including warranty provisions, of the contract intended to govern the sale. A **shrink-wrap license** provides that the purchaser accepts all terms of the license upon opening the package. The purchaser does not see the license containing these provisions until after purchasing and taking possession of the software.

Computer equipment and software are also often purchased online. The purchaser places an order and pays for an item online, but does not see the terms of the sale or license until she opens the box at delivery. At issue is whether the parties have actually agreed to the terms provided in the packaged or shrink-wrapped license. U.S. law has increasingly recognized the shrink-wrap license or contract. The agreement found in the package, or sent by the vendor, typically states something to this effect: "Purchaser's receipt of services [or software] constitutes acceptance of all terms and conditions of this Agreement."

A number of states have passed laws recognizing the shrink-wrap contract. For example, Illinois passed the following law in 1986: "A person who acquires a copy of computer software will be conclusively deemed to have accepted and agreed to those provisions of the license agreement accompanying the copy." However, it places a number of requirements on the seller-licensor before granting the presumption of enforceability. First, there must be a written notation or notice affixed to the package that states clearly that opening the sealed package will constitute acceptance of the terms of the accompanying license agreement. Second, the notice must be clearly and conspicuously visible so as to be readily noticeable to a person viewing the package.

The court in *Arizona Retail Systems v. Software Link*¹⁷ applied Sections 2-207 (additional terms) and 2-209 (modification) of the Uniform Commercial Code to a shrink-wrap license. The issue in the case was whether a disclaimer of implied warranties found in the license had become a part of the contract. The court rejected the argument that the terms of the shrink-wrap license included in each package of software were additional terms under Section 2-207's battle of the forms scenario or a modification of the contract under Section 2-209.

The court concluded that, at best, the license agreement was "a proposal to modify the contract between the parties." Thus, unless expressly agreed to by the purchaser, the warranty disclaimer did not become a part of the contract since the license was delivered after the contract had already been formed. The court suggested that sellers should protect themselves by not shipping until they obtain assent to those terms they consider essential to the formation of a contract.

Shrink-wrap contracts are generally a U.S. phenomenon. If an international seller hopes to use a shrink-wrap contract, it should determine if such a contract is recognized in the country of importation. In order to protect the seller of software, it may be necessary to require its foreign sales representative or agent to procure a signature on the license agreement from the foreign purchaser.

Another modern form of contracting is the **click-wrap license**. Consumers often purchase software over the Internet. After providing the necessary payment information, the purchaser is allowed to directly download the software; however, the purchaser must first agree to the terms of the software license. In order to do so she must click the "accept" icon. The problem is that the actual license is embedded in another file that the purchaser can easily ignore. Thus, web pages can be designed to obtain the purchaser's "acceptance" with very little likelihood that the purchaser will actually view the terms of the offer.

International E-Commerce Developments

Developments in e-commerce and Internet law are ongoing at both the national and international level. The International Chamber of Commerce published in 1997 a guide titled **General Usage for International Digitally**

Ensured Commerce (GUIDEC) that addresses some of the definitional and legal aspects relating to methods of overcoming e-commerce **authentication** and confidentiality problems. GUIDEC gives a general framework for ensuring (authenticating) and certifying digital messages. In order to do this, it had to develop some original nomenclature as well as provide “clear descriptions of the rights and responsibilities of subscribers, certifiers, and relying parties.” GUIDEC’s operative concept of affixing a signature or verifying the author of the data message is referred to as ensuring. The stated goals of GUIDEC are “to enhance the ability of the international business community, to execute secure digital transactions, to establish legal principles that promote reliable digital ensuring and certification practices, and to define and clarify the duties of participants in the emerging ensuring and certification system.”

On June 13, 1997, Germany enacted a broad Multi-Media Law, titled the Federal Act Establishing the General Conditions for Information and Communications Services or “Information and Services Act.” One of the substantive provisions of the Act calls for at least a limited amount of liability for **Internet service providers (ISPs)** for the content of materials accessed through their services. However, this liability extends only if the ISP knew of the content and has the technical means to prevent its use. The law provides a reasonableness standard in determining if the ISP is jointly liable with the creator or provider of the material. Similar limitations of liability for ISPs are found in the U.S. Digital Millennium Copyright Act of 1998.

The EU has made recent strides to deal with the issues impeding the development of EDI and electronic commerce. In 1997, the European Commission published the “European Initiative on Electronic Commerce” or COM (97) 157. Before that initiative, the EU’s first foray into e-commerce was the publication of a **Model EDI Agreement**.¹⁸ The Model Agreement guides contracting parties on a number of important topics including the regulation of the processing and acknowledgment of EDI messages, security precautions, operational requirements, and confidentiality protections.

United Nations Model Law on Electronic Commerce

The United Nations Commission on International Trade Law (UNCITRAL) adopted the **Model Law on Electronic Commerce** (Model Law) on June 12, 1996.¹⁹ The Model Law provides “a *framework* law that does not itself set forth all the rules and regulations that may be necessary to implement those techniques in an enacting country.” The law potentially serves three purposes. Individual governments can use it as a model or guide in drafting national legislation. The law can be used as a source of language for contract drafting purposes or as a set of default rules incorporated into a contract by reference. Finally, courts and arbitration panels may use it “in interpreting existing international conventions and other instruments as far as they impede electronic commerce.”

The United Nations also published a **Guide to Enactment** (Guide) to be used in conjunction with the Model Law.²⁰ The Guide states that the Model Law is not intended to displace national rules of contracting. It takes no position on whether a contract is formed upon dispatch of the acceptance (common law) or upon receipt (civil law). However, it does provide uniform rules for determining when something is dispatched or received. Article 15 provides that an offer or acceptance is dispatched when the sender presses the “enter button.” They are received when the message enters the information system of the addressee. It further notes that an e-mailbox can be the information system of the addressee. Also of importance is *the place of dispatch or receipt* for determining the law of the contract and the appropriate court in which to bring a lawsuit. Under Article 15 (4) of the Model Law, the place of dispatch is the place of business of the sender. Therefore, the contract is concluded at the place of the sender. This will be important when there is no express choice of law.

Article 1 of the Model Law provides two important concepts in determining its sphere of application. First, it is to be used in the “context of commercial activities,” although it does not negate its application to consumer transactions. Second, it is intended to provide “media-neutral rules.” Its goal is to eliminate any differences between the legality of electronic contracts and paper based contracts. Article 5 of the Model Law establishes the fundamental principle that under law “there should be no disparity of treatment between data messages and paper documents.” Also, it is meant to be open ended in order to be adaptable to future developments in technology.

The notion of *incorporation by reference* is regarded as essential to the widespread use of EDI, electronic mail, digital certificates, and other forms of electronic commerce. The Guide suggests the following conditions: (1) reference clause should be inserted into the data message, (2) document being referenced should be brought to the attention of the other party, and (3) other party should expressly consent to the incorporation of the document. Therefore, in an online contracting environment where reference is made to the “general terms and conditions” of the seller, the application or form contract should clearly reference the document and make it

The Parties recognize the economic growth and opportunity that electronic commerce provides, the importance of avoiding barriers to its use and development, and the applicability of the WTO Agreement to measures affecting electronic commerce. The Parties affirm that measures affecting the supply of services delivered or performed electronically are subject to the same obligations as the sale of goods.

Article 15.3: Digital Products

Neither Party may impose customs duties, fees, or other charges on or in connection with the importation or exportation of: (a) if it is an originating good, a digital product fixed on a carrier medium; or (b) a digital product transmitted electronically. Neither Party may accord less favorable treatment to some digital products than it accords to other like digital products (a) on the basis that: (i) the digital products receiving less favorable treatment are created, produced, published, stored, transmitted, contracted for, commissioned, or first made available on commercial terms in one of the countries. Nothing in the agreement precludes a Party from imposing internal taxes or other internal charges on digital products. The Committee on Trade in Goods shall consult on and endeavor to resolve any difference that may arise between the Parties.

Neither Party may accord less favorable treatment to digital products: (a) created, produced, published, contracted for, commissioned, or first made available on commercial terms in one of the countries than it accords to like digital products created, produced, published, contracted for, commissioned, or first made available on commercial terms in a non-Party country; Paragraph 2 does not apply to: (a) subsidies or grants that a Party provides to a service or service supplier, including government-supported loans, guarantees, and insurance; or (b) services supplied in the exercise of governmental authority.

Article 15.4: Electronic Authentication and Electronic Signatures

Neither Party may adopt or maintain legislation for electronic authentication that would: (a) prohibit parties to an electronic transaction from mutually determining the appropriate authentication methods for that transaction; (b) prevent parties from having the opportunity to establish before judicial or administrative authorities that their electronic transaction complies with any legal requirements with respect to authentication; or (c) deny a signature legal validity solely on the basis that the signature is in electronic form.

Article 15.5: Online Consumer Protection

The Parties recognize the importance of maintaining and adopting transparent and effective measures to protect consumers

from fraudulent and deceptive commercial practices when they engage in electronic commerce. The Parties recognize the importance of cooperation between their respective national consumer protection agencies on activities related to cross-border electronic commerce in order to enhance consumer welfare. Each Party's national consumer protection enforcement agencies shall endeavor to cooperate with those of the other Party.

Article 15.6: Paperless Trading

Each Party shall endeavor to make trade administration documents available to the public in electronic form. Each Party shall endeavor to accept trade administration documents submitted electronically as the legal equivalent of the paper version of those documents.

Article 15.7: Access and Use of the Internet for E-Commerce

To support the development and growth of electronic commerce, each Party recognizes that consumers should be able to: (a) access and use services and digital products of their choice, unless prohibited by the Party's law; (b) run applications and services of their choice, subject to the needs of law enforcement; (c) connect their choice of devices to the Internet, provided that such devices do not harm the network and are not prohibited by the Party's law; and (d) have the benefit of competition among network providers, application and service providers, and content providers.

Article 15.8: Cross-Border Information Flows

Recognizing the importance of the free flow of information in facilitating trade, and acknowledging the importance of protecting personal information, the Parties shall endeavor to refrain from imposing or maintaining unnecessary barriers to electronic information flows across borders.

Article 15.3 above ensures that digital products that are exported or imported between the two countries will pass duty free, whether they are delivered in a fixed medium or electronically transferred. The final provision focuses on the flow of data and personal information and prohibits the imposition of unnecessary barriers to electronic information flows. This is an obvious reaction by the US to the EU's imposition of privacy laws aimed at regulating the flow of such information in order to protect the privacy rights of its citizens. Along these lines, Article 15.5 requires the countries' consumer protection agencies to cooperate in order to protect consumers from fraudulent and deceptive commercial practices conducted over the Internet.

Figure 21.4 *Comparative Law: 2012 Korea–U.S. Free Trade Agreement.*²¹

available for review. For first time users, the online site may automatically bring up the referenced document before allowing the user to effectuate a transaction.

The Model Law views the place of dispatch as crucial for determining the important issue of the law of the contract and the appropriate court in which to bring a lawsuit. Under Article 15(4) of the Model Law, the place of dispatch is the place of business of the sender. Therefore, the contract is concluded at the place of the sender. This will be important when there is no express choice of law.

In contrast, Europe's **Brussels Convention** establishes the domicile of the defendant as the fundamental ground for jurisdiction. Article 5 of the Convention provides, however, that the place of performance can be an alternative ground for jurisdiction. For delivery of goods, this would generally be the customer's address. Interestingly, for the online sale and transmission of software, the place of performance will be the place of the service provider, where the data is received. This may not be the same country as where the defendant is located.²² Regarding choice of law, the **Rome Convention** on law applicable to contractual obligations provides that the contract, in the absence of a choice of law clause, is to be governed "by the law of the country with which it is most closely connected." Article 4(2) provides a presumption in favor of the performing party's principal place of business.

The notion of incorporation by reference is highlighted in Section 46 of GUIDEC. It states that "incorporation by reference is regarded as essential to the widespread use of EDI, electronic mail, digital certificates, [public key certificates], and other forms of electronic commerce. For example, electronic communications are typically structured in such a way that large numbers of messages are exchanged, with each message contracting bits of information, and relying much more frequently than paper documents on reference to information accessible elsewhere."

The United Nations approved for ratification in July 2005 a version of the Model Law entitled **Convention on the Use of Electronic Communications in International Contracts (UECIC)**.²³ The UECIC entered into force on March 1, 2013. Like the Model Law, UECIC provides rules for: (1) legal recognition of electronic communications; (2) dispatch and receipt of communications (electronic mailbox rule); (3) rules for determination of "invitations to offer"; (4) use of electronic agents; and (5) liability for errors, right to correct, and the right to withdraw.

Free Trade Agreements

The importance of international e-commerce is recognized by the newer generation of free trade agreements. See the excerpts presented in Figure 21.4 *Comparative Law*: "2012 Korea–U.S. Free Trade Agreement," which are the operative provisions relating to e-commerce.

Internet and Small Businesses

Thus, the Internet has been a facilitator in the expansion of international trade by allowing sales of low volume, low cost goods to overcome prohibitive transactions costs to such types of transactions. Of course, the Internet has also facilitated transaction between medium and large-sized companies. It has had a large impact in allowing all sized companies that previously sold only to the domestic market to expand their sales to the international marketplace. Despite the amazing business tool and the ubiquitousness of the Internet, it has also presented new risks and pitfalls for the unwary or unsophisticated entrepreneur. The risks particular to Internet sales are dependent on the characteristics of the parties. The scenario to be discussed here is one in which either the exporter or importer (or both) is an individual or a small company and the parties have had no previous dealings. The best conclusion is that the devices used to minimize such risks in larger transactions or between larger companies should be employed, as much as is practical, in smaller Internet transactions.

Before exporting goods through an Internet sale, the exporter will need to classify the product for purposes of export and import regulations. The determination of the classification should be made in consultation with the importer. This is because the classification of the goods will determine the tariff rate charged by the country of import, as well as the applicability of quantitative restrictions, such as quotas. Shipping companies, custom brokers,

and government customs agents use product information in the transport and importation of the goods. The information is used in the production of important documents, such as certificate of origin, packing slips, and commercial invoice, which are in turned used by government export-import systems.

The classification of goods is done using the harmonized tariff schedule (HTS) in which a ten-digit number is assigned to the product. It is a harmonized schedule because the first six digits are the same in all countries. The United States adds an additional four digits for purposes of goods being imported into the United States, while goods being exported out of the United States need only bear the first six numbers. Based upon this number the importing country assigns a tariff rate to collect duties. For example, men's wool overcoats without fur are charged a tariff rate of 9.1 percent, while men's wool overcoats with fur lining are charged at a rate of 12.8 percent.²⁴

The selection of the classification number is initially at the discretion of the exporter and importer. The parties should do an honest job in selecting the most specific code number that characterizes the goods because the initial HTS number selected will be subject to review and challenge by government authorities. That said, there are thousands of HTS code numbers so there is a bit of discretion in selecting the correct classification as different code numbers may have different tariff rates. Figures 21.5 and 21.6 provide brief case studies on two companies' entry into exporting its goods and the lessons learned. The first case study highlights the importance of properly classifying exported goods and the use of suppliers to provide the necessary information. The second case study illustrates the use of export management consultants to facilitate a company's export function.

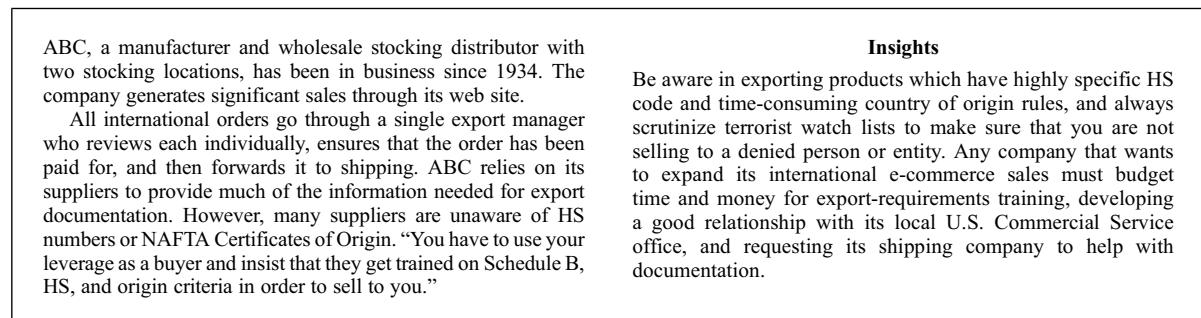


Figure 21.5 *Focus on Transactions*: Case Study: Exporting for the First Time.²⁵



Figure 21.6 *Doing Business Internationally*: Case Study: Export Management Consultants.

Payment Methods

Companies that use the Internet to reach overseas customers frequently use their web site to process orders and accept payments. Since payment practices vary from country to country, it is important to identify and incorporate the prevalent payment mechanisms into the order-processing component of the web site. The available options include credit card payments, account-to-account transfers, person-to-person transfers, and escrow transactions.

Most overseas customers use credit cards for online purchases. To offer credit card payment services, a company must establish a credit card merchant account with a bank. The bank will process the transactions in exchange for a fee. Companies should compare the fee structures of banks to determine which would work best for the size and number of expected sales. Account-to-account (A2A) transfers, which involve the electronic transfer of money between a customer's and a merchant's bank, are popular in many countries. A2A transactions, which occur in real time, offer the additional advantage of reducing the potential for fraud.

A person-to-person transfer is when payment is sent electronically to a third party, which in turn deposits the funds in the merchant's account. PayPal has become one of the most popular P2P service providers. PayPal lets anyone with an e-mail address use a credit card or bank account to securely send and receive online payments. PayPal will also conduct currency exchange, allowing the customer and the merchant to operate in their preferred currency.

An escrow service is a long-standing payment method now used for export. By definition, an escrow service reduces the potential risk of fraud by acting as a trusted third party that collects, holds, and disburses funds according to exporter and importer instructions.²⁶

Ways to minimize the risks of nonpayment or nondelivery include use of country exclusions, card verification numbers, IP geolocation, and background checks. *Country exclusion* is the simple tactic of not transacting business with parties in countries where the risk of fraud is high. This is especially important for small companies testing out new markets. *Card verification numbers (CVNs)* are the three- or four-digit security codes found on credit cards. It is a number only available to the cardholder; so requiring it helps reduce the chance of fraud. However, such numbers could also be stolen, reducing the CVN's effectiveness as a fraud-prevention tool. *IP geolocation* is a service that is available from various companies enabling a seller to identify a prospective buyer's geographic location (country, region, ZIP/postal code) based on the IP address of the computer being used. If the country or region of the buyer's credit card address doesn't match that of the IP address, the seller investigates or rejects the order. *Background checks* are seen mostly in larger business-to-business transactions and should also be used before hiring a foreign agent or distributor. Background checks may include purchasing a credit report on the prospective buyer or calling references. The U.S. Commercial Service's International Company Profile can also be used.²⁷ Background checks can be costly and time-consuming.

FBI: Internet Fraud Tips: For information on the most common complaints and scams, see the annual reports of the Internet Crime Complaint Center (IC3), a partnership of the FBI and the National White Collar Crime Center. To minimize the risk of delivery an import-buyer should obtain a physical address rather than simply a post office box and a telephone number, and call the seller to see if the telephone number is correct and working; send e-mail to the seller to make sure the e-mail address is active; make sure the transaction is secure when you electronically send your credit card numbers; and use an escrow or alternate payment service.

Taxation

Taxation is as relevant to online merchants as to brick-and-mortar businesses. In general, for most overseas markets, a company must have a permanent establishment in a foreign country before that country can subject the company to its general tax jurisdiction. Thus, an American online vendor of digitally or physically delivered goods that does not have equipment or personnel in Japan would not be subject to Japanese taxation. However,

there are important exceptions to this general rule. On July 1, 2003, the EU member states began taxing sales of electronically supplied goods and services from non-EU companies to customers located in the EU. Non-EU providers of electronic goods and services are now required to register with a tax authority in the member state of their choosing and to collect and remit value-added tax (VAT) at the VAT rate of the member state in which their customer is located. Although the EU countries have been the first to move toward a system of taxing electronic sales according to customer location (regardless of where the vendor is established), other countries may soon follow suit. Therefore, if your company exports online, you must know about the tax requirements of your target market.

Privacy

U.S. organizations that collect personally identifiable information online should display their privacy policies prominently and offer their data subjects (e.g., customers, employees, and other business contacts) options regarding the use of their personal information. Customers should have the opportunity to refuse having their personal information shared with others or used for promotional purposes. Many countries have privacy laws, and organizations should take care to comply or they may face prosecution. For example, the EU prohibits the transfer of personal data to non-EU nations that do not meet the EU “adequacy” standard for privacy protection. The U.S. Department of Commerce, in consultation with the European Commission and the private sector, has developed a safe-harbor framework that provides U.S. organizations with a streamlined means to comply with the EU requirements. Companies may self-certify to the safe harbor at www.export.gov/safeharbor.

Electronic Documentation

In the documentary transaction that is central to the exportation of goods, “paper” is becoming less vital. Cost savings generated by electronic transmission are likely to foster increased use of the electronic communication of documents. “In the transport industry, the cost of raising conventional documents and the attendant delays involved in their issuance and verification constitute 10 percent to 15 percent of total transportation costs.”²⁸ In order to generate cost savings, contracts will be electronically formed, electronic bills of lading will be sent to a third-party record-keeping service, letters of credit will be issued based upon a preexisting template, and other necessary documents like insurance certificates will be requested and transmitted by computers. The realization that a bill of lading need not be in writing in order to effect a transfer of title led the Comité Maritime International (CMI) to produce the 1990 Rules for Electronic Bills of Lading. In addition, most of the documents involved in the contract formation process (*pro forma* invoice, purchase order, confirmations) can be transmitted through EDI.

Bolero Project

Bolero originated from an EU-funded research initiative tasked with establishing a global cross-industry solution to enable the use of e-documentation for cross border trade. In 1995 the Bolero Association was created with members from across Europe, the USA, and Asia. The Bolero “concept” was to develop a central “registry” for all trade-related documents of title and to ensure that any documents sent over Bolero would have the same legal meaning as the paper document. In 1996 it entered into an agreement with SWIFT (bank owned co-operative that secures interbank transmissions) and TT Club (international transport provider of insurance and related risk management services) to create a joint venture company to build, market, and support the Bolero infrastructure.

The initial Bolero infrastructure consisted of a Core Messaging Platform built by SWIFT to meet the functional specification defined by the new Bolero entity; a Title Registry, enabling the fully electronic transfer of title, built under contract to Bolero; and the Bolero Rulebook, a unique multiparty legal agreement. The Bolero service went

fully live in 1999, operated and supported by SWIFT. During 2010, the operation of the Bolero services was successfully transitioned from SWIFT to a leading-edge commercial hosting facility with full SAS 70 compliance.

SAS 70 is the Statement of Auditing Standards. SAS 70 certification is based upon an audit that assesses the quality of a service association's internal controls. Service organizations are entities that provide outsourcing services that impact the control environment of their customers.

Bolero is a now cloud-based platform that links trade with trade finance by providing corporate customers with access to a community of trade enablers, from banks to ocean carriers; users are able to manage their complete financial and trade processes including the use of electronic bills of lading. Bolero delivers this value through a combination of cloud-based technology, extensive domain expertise, and a unique legal infrastructure that underpins and supports the technology, ensuring practical and cultural barriers to adoption are removed. Bolero operates in more than 40 countries and manages more than 400,000 trade transactions per month. All Bolero Applications are built on the Bolero Exchange, which is a collaborative platform that supports all trade flows between all parties and across all locations. Each Bolero member has access to all other community members.

Bolero provides electronic documents for letters of credit, standby letters of credit and bank guarantees, bills of lading, and e-documentation. The Bolero letter of credit (LC) is a multi-banking service that enables companies to interactively manage, view, print, and download their LCs. It also addresses the amendments process and services all types of LCs, including standby LCs. Bolero LC Application manages the lifecycle of the LC, from application through to any notifications and amendments coming back from the issuing bank. Additionally, for every transaction, the Bolero Exchange Platform checks the identity of the parties that are involved as well as the integrity of the transaction data themselves. By removing the traditional paper-based mail and fax communications used today, Bolero customers benefit from the efficiency and accuracy of electronic processing. In the area of bank guarantees, the Bolero system allows companies to work with their banks to manage credit lines; monitor and reconcile fees and charges associated to the guarantee; and improve cash positions by reducing the requirement for working capital.

Bolero has introduced the first *International Group of P&I Clubs* approved **Electronic Bill of Lading (eBL)** and continues to encourage its adoption by the world trade community. An eBL is not simply an electronic version of the paper bill of lading. Rather it is a combination of a legal rulebook and technology that can replicate the functions of a traditional paper bill of lading.

International Group of P&I (Protection and Indemnity) Clubs is the umbrella organization of thirteen insurance underwriter clubs in the world that provide insurance for about 90 percent of international ocean carriage. P&I covers a wide range of ocean carrier liabilities, such as injuries to crew, cargo loss, oil pollution, and dock damage.

Specifically, the Bolero eBL solution comprises the Bolero Rulebook, the Bolero Title Registry, and the Bolero Messaging Platform. The Bolero Rulebook is a common user agreement entered into by all Bolero users. The Bolero Title Registry is a repository that manages the transfer of title of the eBL. The Bolero Exchange platform allows the eBL to replicate the traditional paper process supporting the “sending” of the eBL from party to party, delivers to the holder the eBL without the need for the holder to interact with others, and reduces the risk of fraud. To further reduce the risk of fraud, in May 2015, Bolero entered into a long-term contract with the technology company CSC to guarantee security, access, and compliance for users of its platform.

Finally, Bolero offers a full range of electronic document presentation for all types of transactions including open account and letters of credit issued under eUCP 600. Its system makes it possible to send a complete set of

documents (documentary collections). Under eUCP for letters of credit, Bolero supports the full range of presentation options from paper, mixed, and fully electronic.

eUCP 600 is a supplement to the Uniform Customs and Practice for Documentary Credit (UCP 600). It accommodates the presentation of documents as electronic records alone or in combination with paper documents. Where the eUCP applies, its provisions shall prevail to the extent that they would produce a result different from the application of the UCP.

CBP Electronic Bulletin Board

U.S. Customs and Border Protection (CBP) is an important source for information on the importation of goods. The CBP increasingly provides online processing and import information. For example, some types of products are subject to quotas; once the quota is met, then other importations of that product are prohibited. Therefore when purchasing such products it is important to check “fill levels” for that pertinent quota. The CBP posts the fill levels on the CBP Electronic Bulletin Board in the file called “Quota Threshold Status.” The quota program is generally applied only to commercial and not personal use importations.

It is also important to note that the CBP does not consider *electronic information* downloaded from the Internet subject to tariffs or duties. This applies to any goods or merchandise that are electronically transmitted to the purchaser, such as CDs, books, or posters. However, the unauthorized downloading of copyrighted items is illegal and downloading child pornography is a crime. U.S. CBP has the authority to investigate and prosecute persons involved in such illegal activities.

Internet Securities Offerings

There has been a recent trend to offer investment information and securities over the Internet. This has become possible in the United States because the SEC has relaxed a number of regulatory requirements, openly authorizing **direct public offerings (DPOs)** over the Internet. In its 1995 Release 33-7233, the SEC stated that: “the use of electronic media should be at least an equal alternative to the use of paper-based media. Accordingly, issuer or third-party information that can be delivered in paper under the federal securities laws may be delivered in electronic format.” Thus, companies may make investment information available directly to prospective investors, prospectuses can be posted online or delivered on CD-ROM, and sales may be processed over the Internet. The major obstacle to the sale of initial public offerings stock over the Internet is the absence of a secondary market for the resale of the securities. Already, however, there is evidence of the development of an e-marketplace for stocks not sold on the national securities exchanges.

A problem with electronic securities transactions is fraud. Numerous instances of illegal ponzi and pyramid schemes have been reported, as well as more traditional misrepresentations, such as using the opinion of well-known “investment advisors” who are compensated by the offering party.

In 1998, the SEC created the **Office of Internet Enforcement** to investigate and prosecute cases of Internet securities fraud. Since its establishment the Office of Internet Enforcement has conducted a number of nationwide sweeps of online investment scams. The most common is the “pump and dump,” where promoters make false claims to artificially drive up the price of a stock in order to sell their own shares at a profit. The Internet enables scam artists to provide false information to a large audience quickly and anonymously.

E-Commerce Ethics

Along with the need for an adequate legal support structure, electronic commerce carries numerous ethical concerns. The e-commerce industry needs to develop its own self-regulatory code of ethics in order to provide guidance to those using the World Wide Web, Internet, and other electronic networks to transact business.

The United Nations Educational, Scientific, and Cultural Organization (UNESCO) has raised a number of themes focusing on the ethical, legal, and societal aspects of e-commerce and the information society, including: (1) What is the appropriate role to be played by governmental agencies in providing Internet access to the public? (2) What special measures are needed to help developing countries and disadvantaged communities benefit from available knowledge and information?

UNESCO has noted that while industry and business provide the infrastructure for access to information resources and content, the challenge is to define the concepts of public domain and **universal access** in a global context to promote common public welfare while encouraging private initiative and protecting rightful economic interests.

Another theme addressed by UNESCO is the special plight of developing countries, especially their inability to benefit fully from the new information age. In light of an emerging **digital divide**, how should governments balance commercial interests with moral obligations to promote equitable access? To answer this question it is important to gain an understanding of the practical obstacles to greater access. For example, what are the most important economic obstacles to information access (telecommunications tariffs, Internet access fees, taxes, and duties, for example)?

UNESCO asserts that the principle of free access to and free flow of information as defined in Article 19 of the Universal Declaration on Human Rights must include access to digital media. There is also an important concern that greater access may cause unexpected harm to the culture or society of a developing country. UNESCO asks, how can the cultural, artistic, and scientific heritage of developing countries, including traditional and indigenous information, be suitably protected and made fairly available? UNESCO's plan of action states that the following elements need to be addressed within a global context: (1) broader and fairer access to information and communication networks and services; (2) application of legal exceptions to copyright for developing countries through international conventions; and (3) promotion of freedom of expression while protecting privacy on global networks. The concerns of the access to the Internet and other technologies to lesser-developed countries have been a core focus of the Doha Round of WTO negotiations (see Chapter 6).

Advertising and Marketing Ethics

The International Chamber of Commerce has developed **Guidelines on Advertising and Marketing on the Internet (Guidelines)**. The Guidelines' main philosophical mandate is to encourage advertisers and marketers "to create an electronic environment which all the world's consumers can fully trust." Article 1 states that "all advertising and marketing should be legal, decent, honest, and truthful." Although aspirational in character, the Guidelines do provide some concrete rules:

- Advertisers and marketers should identify themselves and the nature of their connection to any commercial messages placed on the Internet (Article 2).
- The addressees of commercial messages should be clearly informed of the cost of accessing the message or service (Article 3).
- Advertisers and marketers should take reasonable precautions to safeguard the security of their files (Article 5).
- Advertisers and marketers should post a **privacy policy statement** on their online sites.

Another issue of Internet ethics is the obtaining and monitoring of user information without the consent of the user through the use of "cookies" to store information about the user's Internet use, including frequency and what files and pages are accessed. The key fear about cookies is that they give a company the ability to link a user's Internet browsing habits to the user's name and provide that information to other companies. Unlike traditional mass mailing marketing, the use of uninvited bulk e-mails is considered an unethical business practice and violates most **acceptable use policies (AUPs)**. Most Internet service providers' AUPs prohibit users from engaging in bulk e-mail advertising or "spamming." It is prudent for a prospective user to review the AUP of an Internet service provider before engaging its services.

Chapter Summary

- 1 The Internet has transformed the international marketplace by facilitating commercial transactions, seizing at least one-half of the consumer sales market, and creating a larger person-to-person sales market. Internet sales and licensing are regulated by the same laws that apply to storefront sales, but also pose a number of new issues, such as determining the proper forum to settle disputes (personal jurisdiction); spamming and an assortment of Internet abuses, such as fraud and criminal activities; cybersquatting and trademark dilution; privacy of personal information; and the protection of electronic databases.
- 2 Personal jurisdiction refers to the ability of a court to hear a legal dispute based on whether or not it has authority over the defendant (Chapter 4). Court decisions have used numerous factors to make this decision including: type of web site (passive, interactive, electronic storefront); commercial or noncommercial web site; and the type of claim or injury caused. The European Union (EU) has enacted regulations that require Internet retailers to defend themselves in the courts of a consumer located in an EU country.
- 3 The U.S. has passed a number of laws that are applicable to trademark infringement and dilution via the Internet, such as the Federal Trademark Dilution Act of 1995 and the Anti-Cybersquatting Consumer Protection Act.
- 4 The EU has aggressively dealt with the issues of the privacy of personal information collected via the Internet and the protection of electronic databases. Directives 95/46 and 2002/58/EC provide a litany of data quality standards and individual rights, such as access, blocking, correction, and objection rights. American companies have to conform to these Directives, but their ability to do so has been made easier through a Safe Harbor Agreement. EU Directive 96/9/EC on the Legal Protection of Databases creates a *sui generis* or a new category of intellectual property law that provides a 15-year protection period for databases that meet certain requirements. There is no counterpart to this legal regime in the United States.
- 5 For long-standing business relationships, Electronic Data Interchange (EDI) is the oldest and most secure form of electronic transactions. The basis of this relationship is a trading partner agreement entered into by the contracting parties.
- 6 General contract or sales law applies to electronic transactions, however, the Internet has generated a number of legal issues related to e-contracting. Some of these issues include the time of contract formation, contracting with or between electronic agents, and the enforceability of shrink-wrap contracts. A number of hard and soft law legal instruments have been created to provide solutions to issues specific to electronic transactions, such as the Uniform Computer Information Transactions Act, the International Chamber of Commerce's General Usage for International Digitally Ensured Commerce, the United Nations' Model Law on Electronic Commerce, and the Convention on the Use of Electronic Communications in International Contracts. In addition, the new generation of free trade agreements (Chapter 7), such as the 2012 Korea–U.S. FTA, incorporates provisions for the facilitation and protection of e-commerce.
- 7 The Internet has allowed small businesses to enter the international marketplace, but this can be a dangerous proposition for the unsophisticated businessperson. Issues that present themselves include the proper classification of the products being exported, payment methods, tax law, and privacy law. At first, a small business should consider using an export management consultant to ensure compliance with the pertinent home and host country laws.
- 8 Electronic documentation related to the transport of goods (Chapter 13), documentary collections transactions (Chapter 14), and transfer of funds (Chapter 15) has increasingly become reality. Examples include the Bolero Project, electronic bills of lading, and eUCP 600.

Key Terms

Acceptable Use Policies
(AUPs)
Access Contract

Anti-Cybersquatting Consumer
Protection Act
Authentication

Blocking Right
Blurring
Brussels Convention

Click-Wrap License	Fair Credit Reporting Act	Privacy Act of 1994
Convention on the Use of Electronic Communications in International Contracts (UECIC)	Federal Trademark Dilution Act of 1995	Privacy Policy Statement
Digital Divide	General Usage for International Digitally Ensured Commerce (GUIDEC)	Right of Access
Direct Public Offerings (DPOs)	Guidelines on Advertising and Marketing on the Internet	Right of Correction
Directive 95/46 on the Protection and Movement of Personal Data	Guide to Enactment	Right of Objection
Directive 96/9/EC on the Legal Protection of Databases	Internet Service Providers (ISPs)	Rome Convention
Directive 2002/58/EC	Lanham Act	Safe Harbor Agreement
Disclaimer	Minimum Contacts	Shareware
Electronic Agent	Model EDI Agreement	Shrink-wrap License
Electronic Bills of Lading (eBL)	Model Electronic Data Interchange Trading Partner Agreement	Spamming
Electronic Communications Privacy Act of 1986	Model Law on Electronic Commerce	Telecommunications Act of 1996
Electronic Data Interchange	Office of Internet Enforcement	Telephone Consumer Protection Act
Electronic Signature	Personal Jurisdiction	Trading Partner Agreements
E-Marketplace Web Sites		Transactional Web Sites
		Uniform Computer Information Transactions Act (UCITA)
		Universal Access

Chapter Problems

- 1 Marobie released copyrighted clip art for use by the fire service industry. The National Association of Fire Equipment Distributors (NAFED) had a web page on which it placed Marobie's clip art so that any web user could download it. Marobie sued NAFED and Northwest, the provider of the host computer for NAFED's web page, for infringement. Is the Internet service provider liable for infringement? *Marobie-FL, Inc. v. Natl. Assn. of Fire Equipment Distributors*, (1997 WL 709747 (N.D. Ill. 1997)).
- 2 The defendant in a recent case had put up a web site as a promotion for its upcoming Internet service. The service consisted of assigning users an electronic mailbox and then forwarding advertisements for products and services that matched the users' interests to those electronic mailboxes. The defendant planned to charge advertisers and provide users with incentives to view the advertisements. The defendant argues that the court did not possess personal jurisdiction because the web site in its current form was a passive provider of information pertaining to future services. What do you think? *Maritz, Inc. v. Cybergold, Inc.*, 947 F.Supp. 1328 (E.D. Mo. 1996).
- 3 E-Data Corporation ("E-Data") is a Utah corporation with a business office in Connecticut. West Stock, a Washington corporation with its principal place of business in Seattle, Washington, licenses stock photography to commercial users. It has no offices in Connecticut, it owns no property and maintains no financial accounts in this forum, and does not have any employees or other agents in Connecticut. Since December 1995, West Stock has operated "Muse," an Internet-based stock photography service through which purchasers may electronically select a photograph, license its use, pay for that use, and download the image—all via the Internet. E-Data claims that West Stock has infringed on its patent. The patented invention is a system for reproducing information embodied in material objects, such as recordings, video games, motion pictures, books, sheet music, greeting cards and the like, at point-of-sale locations with the permission of the owner of the information. Specifically, plaintiff claims that defendant West Stock infringes the patent when it offers consumers the opportunity to purchase photography images via the Internet by paying a licensing fee to unlock and instantly download photography images on the

consumer's computer. West Stock moves to dismiss contending that the court lacks personal jurisdiction over it in Connecticut. Does the Connecticut court have personal jurisdiction over West Stock? *E-Data Corp. v. Micropatent Corp.*, 989 F. Supp. 173 (D. Conn 1997).

- 4 Sportsman's is a mail order company that is well known in the aviation field. It began using the logo "Sporty" in the 1960s and registered "Sporty's" as a trademark in 1985. It spends about \$10 million a year advertising its Sporty's logo. A competitor, Pilot's Depot, was set up in early 1995 and registered the domain name sportys.com. The competitor then set up another company, Sporty's Farm, which used the domain name sportys.com to advertise the sale of its Christmas trees on that web site. The question before the court was which

company had the right to the domain name. Which company do you think has a right to the domain name? Does Sportsman have to prove that Pilot's Depot acted in bad faith? How does the Anti-Cybersquatting Consumer Protection Act apply to this case? *Sporty's Farm L.L.C. v. Sportsman's Market, Inc.*, 202 F.3d 489 (2nd Cir. 2000).

- 5 Employees may send personal e-mails at work just as they may have personal phone conversations. Do employees have a right of privacy in the e-mails? Do employers have the right to monitor employee e-mail? Does an employer have to notify its employees of its intent to monitor? Can an employer monitor e-mail after stating that it would not monitor? What would be a proper ethical approach to employer monitoring? *Smith v. Pillsbury Co.*, 914 F.Supp. 97 (E.D. Pa., 1996).

Internet Exercises

- 1 (a) Visit the web site of the Cyberspace Law Center at <http://www.cyberlaw.com>. Prepare a report on recent developments in the area of international piracy and patent infringement. (b) Visit the web site of Internet Legal Services at <http://www.legal-ethics.com>. This site covers legal issues dealing with advertising on the Internet and the confidentiality of e-mail. Report on employer and employee rights pertaining to e-mail privacy. (c) Review the directory of firewall and computer security information at <http://www.firewall.com>.
- 2 (a) Review the *International Safe Harbor Privacy Principles* and report on their requirements: <http://export.gov/safeharbor>. (b) Review the privacy policy of a major online retailer such as Amazon or L.L. Bean. (c) Review industry-based privacy principles and programs such as [http://www.bbbon-](http://www.bbbon-line.org)
- line.org (Council of Better Business Bureaus, Inc., privacy program) or <http://www.truste.org> (TRUSTe is an organization of web publishers who have agreed to certain privacy principles).
- 3 The Digital Millennium Copyright Act (DMCA) provides Internet service providers a measure of immunity from liability for illegal content (pornography, defamation). What are the responsibilities of the provider in order to obtain this immunity from prosecution? What are the similarities and differences between DMCA and the German Multi-Media Law discussed in the chapter? For coverage of the DMCA see <http://www.copyright.gov/legislation/dmca.pdf>. For materials on the German Multi-Media Law see <http://www.iid.de>, <http://www.iukdg.de>, or <http://www.bmbf.de>.

Other Internet Sources

Chicago-Kent Law School Project on **Internet Jurisdiction**: <http://www.kentlaw.edu/cyberlaw>.

For a Summary of **UCITA** see <http://www.uniformlaws.org/ActSummary.aspx?title=Computer%20Information%20Transactions%20Act>.

You may download a copy of **GUIDEC II** at <http://www.iccwbo.org/Advocacy-Codes-and-Rules/Document-centre/2001/GUIDEC-General-Usage-for-International-Digitally-Ensured-Commerce-%28Version-II%29-01/10/2001>.

German Internet-Multi-Media law: <http://www.iid.de>, <http://www.iukdg.de>, or <http://www.bmbf.de>.

European Initiative on Electronic Commerce: <http://www.cordis.lu/esprit/src/ecomcom.htm>.

Notes

- 1 Source: U.S. Commercial Service.
- 2 126 F.3d 25 (2d Cir. 1997).
- 3 130 F.3d 414 (9th Cir. 1997). See *CompuServe, Inc. v. Patterson*, 89 F.3d 1257 (6th Cir. 1996) (case finding personal jurisdiction).
- 4 952 F. Supp. 1119 (W.D. Pa. 1997).
- 5 15 U.S.C. 1114.
- 6 15 U.S.C. 1125 (c).
- 7 189 F.3d 868 (9th Cir. 1999).
- 8 141 F.3d 1318.
- 9 1998 Dist. LEXIS 17217 (S.D.N.Y. 1998).
- 10 *Olmstead v. United States*, 277 U.S. 438, 478 (1928).
- 11 15 U.S.C. §§ 1681-1681u (1994).
- 12 47 U.S.C. § 227.
- 13 5 U.S.C. § 552a.
- 14 18 U.S.C. § 2510.
- 15 47 U.S.C.A. § 222 (West Supp. 2000).
- 16 Electronic Messaging Services Task Force, "The Commercial Use of Electronic Data Interchange—A Report and Model Trading Partner Agreement," 45 *Business Lawyer* 1645 (1990).
- 17 831 F.Supp. 759 (D. Ariz 1993).
- 18 Model Agreement may be accessed through Commission Recommendation 94/820/EC (OJ L 338/98 1994) and Council Decision 87/499/EEC (OJ 1987 L 285/35).
- 19 UNCITRAL Model Law on Electronic Commerce: <http://www.un.or.at/uncitral>; U.N. Doc. A/51/17 Annex I (1996), reprinted in 36 I.L.M. 200 (1997).
- 20 United Nations Commission on International Trade, UNCITRAL Model Law on Electronic Commerce with Guide to Enactment (Guide No. 3) (1997).
- 21 Free trade agreement between the United States of America and the Republic of Korea, U.S.–South Korea, June 30, 2007, OFFICE OF THE U.S. TRADE REPRESENTATIVE [hereinafter KORUS FTA], available at <http://www.ustr.gov/trade-agreements/free-trade-agreements/korus-fta/final-text>.
- 22 See Christopher Glatt, "Comparative Issues in the Formation of Electronic Contracts," 6 *Journal of Law and Information Technology* 34, 61–63 (1996).
- 23 See Charles H. Martin, "The UNCITRAL Electronic Contracts Convention: Will It Be Used or Avoided?," 17 *Pace International Law Review* 261 (2005).
- 24 See U.S. Commercial Service, Department of Commerce, *Preparing Your Business for Global E-Commerce* (January 2011).
- 25 U.S. Commercial Service.
- 26 See, e.g., escrow.com.
- 27 See export.gov/salesandmarketing.
- 28 See Amelia H. Boss, "The International Commercial Use of Electronic Data Interchange and Electronic Communications Technologies," 46 *Business Lawyer* 1787 (1991).

APPENDIX

APPENDIX: UNITED NATIONS CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS (CISG; 1980)

(Part IV Final Provisions, Articles 89–101, have been deleted)

THE STATES PARTIES TO THIS CONVENTION,
BEARING IN MIND the broad objectives in the resolutions adopted by the sixth special session of the General Assembly of the United Nations on the establishment of a new International Economic Order,
CONSIDERING that the development of international trade on the basis of equality and mutual benefit is an important element in promoting friendly relations among States,
BEING OF THE OPINION that the adoption of uniform rules which govern contracts for the international sale of goods and take into account the different social, economic and legal systems would contribute to the removal of legal barriers in international trade and promote the development of international trade, HAVE AGREED as follows:

PART I: Sphere of Application and General Provisions

Chapter I: Sphere of Application

ARTICLE 1

- 1 This Convention applies to contracts of sale of goods between parties whose places of business are in different States:
 - a when the States are Contracting States; or
 - b when the rules of private international law lead to the application of the law of a Contracting State.
- 2 The fact that the parties have their places of business in different States is to be disregarded whenever this fact does not appear either from the contract or from any dealings between, or from information disclosed by, the parties at any time before or at the conclusion of the contract.
- 3 Neither the nationality of the parties nor the civil or commercial character of the parties or of the contract is to be taken into consideration in determining the application of this Convention.

ARTICLE 2

This Convention does not apply to sales:

- a of goods bought for personal, family or household use, unless the seller at any time before or at the conclusion of the contract, neither knew nor ought to have known that the goods were bought for any such use;
- b by auction;
- c on execution or otherwise by authority of law;
- d of stocks, shares, investment securities, negotiable instruments or money;
- e of ships, vessels, hovercraft or aircraft;
- f of electricity.

APPENDIX

ARTICLE 3

- 1 Contracts for the supply of goods to be manufactured or produced are to be considered sales unless the party who orders the goods undertakes to supply a substantial part of the materials necessary for such manufacture or production.
- 2 This Convention does not apply to contracts in which the preponderant part of the obligations of the party who furnishes the goods consists in the supply of labour or other services.

ARTICLE 4

This Convention governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract. In particular, except as otherwise expressly provided in this Convention, it is not concerned with:

- a the validity of the contract or of any of its provisions or of any usage;
- b the effect which the contract may have on the property in the goods sold.

ARTICLE 5

This Convention does not apply to the liability of the seller for death or personal injury caused by the goods to any person.

ARTICLE 6

The parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions.

Chapter II: General Provisions

ARTICLE 7

- 1 In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.
- 2 Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.

ARTICLE 8

- 1 For the purposes of this Convention statements made by and other conduct of party are to be interpreted according to his intent where the other party knew or could not have been unaware what that intent was.
- 2 If the preceding paragraph is not applicable, statements made by and other conduct of a party are to be interpreted according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances.
- 3 In determining the intent of a party or the understanding a reasonable person would have had, due consideration is to be given to all relevant circumstances of the case including the negotiations, any practices which the parties have established between themselves, usage and any subsequent conduct of the parties.

APPENDIX

ARTICLE 9

- 1 The parties are bound by any usage to which they have agreed and by any practices which they have established between themselves.
- 2 The parties are considered, unless otherwise agreed, to have impliedly made applicable to their contract or its formation a usage of which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned.

ARTICLE 10

For the purposes of this Convention:

- a if a party has more than one place of business, the place of the business is that which has the closest relationship to the contract and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of the contract;
- b if a party does not have a place of business, reference is to be made to his habitual residence.

ARTICLE 11

A contract of sale need not be concluded in or evidenced by writing and is not subject to any other requirement as to form. It may be proved by any means, including witnesses.

ARTICLE 12

Any provision of article 11, article 29 or Part 11 of this Convention that allows a contract of sale or its modification or termination by agreement or any offer, acceptance or other indication of intention to be made in any form other than in writing does not apply where any party has his place of business in a Contracting State which has made a declaration under article 96 of this Convention. The parties may not derogate from or vary the effect of this article.

ARTICLE 13

For the purposes of this Convention “writing” includes telegram and telex.

PART II: Formation of the Contract

ARTICLE 14

- 1 A proposal for concluding a contract addressed to one or more specific persons constitutes an offer if it is sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance. A proposal is sufficiently definite if it indicates the goods and expressly or implicitly fixes or makes provision for determining the quantity and the price.
- 2 A proposal other than one addressed to one or more specific persons is to be considered merely as an invitation to make offers, unless the contrary is clearly indicated by the person making the proposal.

ARTICLE 15

- 1 An offer becomes effective when it reaches the offeree.
- 2 An offer, even if it is irrevocable, may be withdrawn if the withdrawal reaches the offeree before or at the same time as the offer.

APPENDIX

ARTICLE 16

- 1 Until a contract is concluded an offer may be revoked if the revocation reaches the offeree before he has dispatched an acceptance.
- 2 However, an offer cannot be revoked:
 - a if it indicates, whether by stating a fixed time for acceptance or otherwise, that it is irrevocable; or
 - b if it was reasonable for the offeree to rely on the offer as being irrevocable and the offeree has acted in reliance on the offer.

ARTICLE 17

An offer, even if it is irrevocable, is terminated when a rejection reaches the offeror.

ARTICLE 18

- 1 A statement made by or other conduct of the offeree indicating assent to an offer is an acceptance. Silence or inactivity does not in itself amount to acceptance.
- 2 An acceptance of an offer becomes effective at the moment the indication of assent reaches the offeror. An acceptance is not effective if the indication of assent does not reach the offeror within the time he has fixed or, if no time is fixed, within a reasonable time, due account being taken of the circumstances of the transaction, including the rapidity of the means of communication employed by the offeror. An oral offer must be accepted immediately unless the circumstances indicate otherwise.
- 3 However, if, by virtue of the offer or as a result of practices which the parties have established between themselves or of usage, the offeree may indicate assent by performing an act, such as one relating to the dispatch of the goods or payment of the price, without notice to the offeror, the acceptance is effective at the moment the act is performed, provided that the act is performed within the period of time laid down in the preceding paragraph.

ARTICLE 19

- 1 A reply to an offer which purports to be an acceptance but contains additions, limitations or other modifications is a rejection of the offer and constitutes a counter-offer.
- 2 However, a reply to an offer which purports to be an acceptance but contains additional or different terms which do not materially alter the terms of the offer constitutes an acceptance, unless the offeror, without undue delay, objects orally to the discrepancy or dispatches a notice to that effect. If he does not so object, the terms of the contract are the terms of the offer with the modifications contained in the acceptance.
- 3 Additional or different terms relating, among other things, to the price, payment, quality and quantity of the goods, place and time of delivery, extent of one party's liability to the other or the settlement of disputes are considered to alter the terms of the offer materially.

ARTICLE 20

- 1 A period of time for acceptance fixed by the offeror in a telegram or a letter begins to run from the moment the telegram is handed in for dispatch or from the date shown on the letter or, if no such date is shown, from the date shown on the envelope. A period of time for acceptance fixed by the offeror by telephone, telex or other means of instantaneous communication, begins to run from the moment that the offer reaches the offeree.
- 2 Official holidays or non-business days occurring during the period for acceptance are included in calculating the period. However, if a notice of acceptance cannot be delivered at the address of the offeror on the last day of the period because that day falls on an official holiday or a non-business day at the place of business of the offeror, the period is extended until the first business day which follows.

APPENDIX

ARTICLE 21

- 1 A late acceptance is nevertheless effective as an acceptance if without delay the offeror orally so informs the offeree or dispatches a notice to that effect.
- 2 If a letter or other writing containing a late acceptance shows that it has been sent in such circumstances that if its transmission had been normal it would have reached the offeror in due time, the late acceptance is effective as an acceptance unless, without delay, the offeror orally informs the offeree that he considers his offer as having lapsed or dispatches a notice to that effect.

ARTICLE 22

An acceptance may be withdrawn if the withdrawal reaches the offeror before or at the same time as the acceptance would have become effective.

ARTICLE 23

A contract is concluded at the moment when an acceptance of an offer becomes effective in accordance with the provisions of this Convention.

ARTICLE 24

For the purposes of this part of the Convention, an offer, declaration of acceptance or any other indication of intention “reaches” the addressee when it is made orally to him or delivered by any other means to him personally, to his place of business or mailing address or, if he does not have a place of business or mailing address, to his habitual residence.

PART III: Sale of Goods

Chapter I: General Provisions

ARTICLE 25

A breach of contract committed by one of the parties is fundamental if it results in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have foreseen such a result.

ARTICLE 26

A declaration of avoidance of the contract is effective only if made by notice to the other party.

ARTICLE 27

Unless otherwise expressly provided in this Part of the Convention, if any notice, request or other communication is given or made by a party in accordance with this Part and by means appropriate in the circumstances, a delay or error in the transmission of the communication or its failure to arrive does not deprive that party of the right to rely on the communication.

ARTICLE 28

If, in accordance with the provisions of this Convention, one party is entitled to require performance of any obligation by the other party, a court is not bound to enter a judgement for specific performance unless the court would do so under its own law in respect of similar contracts of sale not governed by this Convention.

APPENDIX

ARTICLE 29

- 1 A contract may be modified or terminated by the mere agreement of the parties.
- 2 A contract in writing which contains a provision requiring any modification or termination by agreement to be in writing may not be otherwise modified or terminated by agreement. However, a party may be precluded by his conduct from asserting such a provision to the extent that the other party has relied on that conduct.

Chapter H: Obligations of the Seller

ARTICLE 30

The seller must deliver the goods, hand over any documents relating to them and transfer the property in the goods, as required by the contract and this Convention.

Section I: Delivery of the Goods and Handing Over of Documents

ARTICLE 31

If the seller is not bound to deliver the goods at any other particular place, his obligation to deliver consists:

- a If the contract of sale involves carriage of the goods – in handing the goods over to the first carrier for transmission to the buyer;
- b if, in cases not within the preceding subparagraph, the contract relates to specific goods, or unidentified goods to be drawn from a specific stock or to be manufactured or produced, and at the time of the conclusion of the contract the parties knew that the goods were at, or were to be manufactured or produced at a particular place – in placing the goods at the buyer's disposal at that place;
- c in other cases – in placing the goods at the buyer's disposal at the place where the seller had his place of business at the time of the conclusion of the contract.

ARTICLE 32

- 1 If the seller, in accordance with the contract or this Convention, hands the goods over to a carrier and if the goods are not clearly identified to the contract by markings on the goods, by shipping documents or otherwise, the seller must give the buyer notice of the consignment specifying the goods.
- 2 If the seller is bound to arrange for carriage of the goods, he must make such contracts as are necessary for carriage to the place fixed by means of transportation appropriate in the circumstances and according to the usual terms for such transportation.
- 3 If the seller is not bound to effect insurance in respect of the carriage of goods, he must, at the buyer's request, provide him with all available information necessary to enable him to effect such insurance.

ARTICLE 33

The seller must deliver the goods:

- a if a date is fixed by or determinable from the contract, on that date;
- b if a period of time is fixed by or determinable from the contract, at any time within that period unless circumstances indicate that the buyer is to choose a date; or
- c in any other case, within a reasonable time after the conclusion of the contract.

APPENDIX

ARTICLE 34

If the seller is bound to hand over documents relating to the goods, he must hand them over at the time and place and in the form required by the contract. If the seller has handed over documents before that time, he may, up to that time, cure any lack of conformity in the documents, if the exercise of this right does not cause the buyer unreasonable inconvenience or unreasonable expense. However, the buyer retains any right to claim damages as provided for in this Convention.

Section II: Conformity of the Goods and Third Party Claims

ARTICLE 35

- 1 The seller must deliver goods which are of the quantity, quality and description required by the contract and which are contained or packaged in the manner required by the contract.
- 2 Except where the parties have agreed otherwise, the goods do not conform with the contract unless they:
 - a are fit for the purposes for which goods of the same description would ordinarily be used;
 - b are fit for any particular purpose expressly or impliedly made known to the seller at the time of the conclusion of the contract, except where the circumstances show that the buyer did not rely, or that it was unreasonable for him to rely, on the seller's skill and judgement;
 - c possess the qualities of goods which the seller has held out to the buyer as a sample or model;
 - d are contained or packaged in the manner usual for such goods or, where there is no such manner, in a manner adequate to preserve and protect the goods.
- 3 The seller is not liable under subparagraphs (a) to (d) of the preceding paragraph for any lack of conformity of the goods if at the time of the conclusion of the contract the buyer knew or could not have been unaware of such lack of conformity.

ARTICLE 36

- 1 The seller is liable in accordance with the contract and this Convention for any lack of conformity which exists at the time when the risk passes to the buyer, even though the lack of conformity becomes apparent only after that time.
- 2 The seller is also liable for any lack of conformity which occurs after the time indicated in the preceding paragraph and which is due to a breach of any of his obligations, including a breach of any guarantee that for a period of time the goods will remain fit for their ordinary purpose or for some particular purpose or will retain specified qualities or characteristics.

ARTICLE 37

If the seller has delivered goods before the date for delivery, he may, up to that date, deliver any missing part or make up any deficiency in the quantity of the goods delivered, or deliver goods in replacement of any non-conforming goods delivered or remedy any lack of conformity in the goods delivered, provided that the exercise of this right does not cause the buyer unreasonable inconvenience or unreasonable expense. However, the buyer retains any right to claim damages as provided for in this Convention.

ARTICLE 38

- 1 The buyer must examine the goods, or cause them to be examined, within as short a period as is practicable in the circumstances.

APPENDIX

- 2 If the contract involves carriage of the goods, examination may be deferred until after the goods have arrived at their destination.
- 3 If the goods are redirected in transit or redispached by the buyer without a reasonable opportunity for examination by him and at the time of the conclusion of the contract the seller knew or ought to have known of the possibility of such redirection or redispach, examination may be deferred until after the goods have arrived at the new destination.

ARTICLE 39

- 1 The buyer loses the right to rely on a lack of conformity of the goods if he does not give notice to the seller specifying the nature of the lack of conformity within a reasonable time after he has discovered it or ought to have discovered it.
- 2 In any event, the buyer loses the right to rely on a lack of conformity of the goods if he does not give the seller notice thereof at the latest within a period of two years from the date on which the goods were actually handed over to the buyer, unless this time limit is inconsistent with a contractual period of guarantee.

ARTICLE 40

The seller is not entitled to rely on the provisions of articles 38 and 39 if the lack of conformity relates to facts of which he knew or could not have been unaware and which he did not disclose to the buyer.

ARTICLE 41

The seller must deliver goods which are free from any right or claim of a third party, unless the buyer agreed to take the goods subject to that right or claim. However, if such right or claim is based on industrial property or other intellectual property, the seller's obligation is governed by article 42.

ARTICLE 42

- 1 The seller must deliver goods which are free from any right or claim of a third party based on industrial property or other intellectual property, of which at the time of the conclusion of the contract the seller knew or could not have been unaware, provided that the right or claim is based on industrial property or other intellectual property:
 - a under the law of the State where the goods will be resold or otherwise used, if it was contemplated by the parties at the time of the conclusion of the contract that the goods would be resold or otherwise used in that State; or
 - b in any other case, under the law of the State where the buyer has his place of business.
- 2 The obligation of the seller under the preceding paragraph does not extend to cases where:
 - a at the time of the conclusion of the contract the buyer knew or could not have been unaware of the right or claim; or
 - b the right or claim results from the seller's compliance with technical drawing, designs, formula or other such specifications furnished by the buyer.

ARTICLE 43

- 1 The buyer loses the right to rely on the provisions of article 41 or article 42 if he does not give notice to the seller specifying the nature of the right or claim of the third party within a reasonable time after he has become aware or ought to have become aware of the right or claim.

APPENDIX

- 2 The seller is not entitled to rely on the provisions of the preceding paragraph if he knew of the right or claim of the third party and the nature of it.

ARTICLE 44

Notwithstanding the provisions of paragraph (1) of article 39 and paragraph (1) of article 43, the buyer may reduce the price in accordance with article 50 or claim damages, except for loss of profit, if he has a reasonable excuse for his failure to give the required notice.

Section III: Remedies for Breach of Contract by the Seller

ARTICLE 45

- 1 If the seller fails to perform any of his obligations under the contract or this Convention, the buyer may:
 - a exercise the rights provided in articles 46 to 52;
 - b claim damages as provided in articles 74 to 77.
- 2 The buyer is not deprived of any right he may have to claim damages by exercising his right to other remedies.
- 3 No period of grace may be granted to the seller by a court or arbitral tribunal when the buyer resorts to a remedy for breach of contract.

ARTICLE 46

- 1 The buyer may require performance by the seller of his obligations unless the buyer has resorted to a remedy which is inconsistent with this requirement.
- 2 If the goods do not conform with the contract, the buyer may require delivery of substitute goods only if the lack of conformity constitutes a fundamental breach of contract and a request for substitute goods is made either in conjunction with notice given under article 39 or within a reasonable time thereafter.
- 3 If the goods do not conform with the contract, the buyer may require the seller to remedy the lack of conformity by repair, unless this is unreasonable having regard to all the circumstances. A request for repair must be made either in conjunction with notice given under article 39 or within a reasonable time thereafter.

ARTICLE 47

- 1 The buyer may fix an additional period of time of reasonable length for performance by the seller of his obligations.
- 2 Unless the buyer has received notice from the seller that he will not perform within the period so fixed, the buyer may not, during that period, resort to any remedy for breach of contract. However, the buyer is not deprived thereby of any right he may have to claim damages for delay in performance.

ARTICLE 48

- 1 Subject to article 49, the seller may, even after the date for delivery, remedy at his own expense any failure to perform his obligations, if he can do so without unreasonable delay and without causing the buyer unreasonable inconvenience or uncertainty of reimbursement by the seller of expenses advanced by the buyer. However, the buyer retains any right to claim damages as provided for in this Convention.
- 2 If the seller requests the buyer to make known whether he will accept performance and the buyer does not comply with the request within a reasonable time, the Seller may perform within the time indicated in his request. The buyer may not, during that period of time, resort to any remedy which is inconsistent with performance by the seller.

APPENDIX

- 3 A notice by the seller that he will perform within a specified period of time is assumed to include a request, under the preceding paragraph, that the buyer make known his decision.
- 4 A request or notice by the seller under paragraph (2) or (3) of this article is not effective unless received by the buyer.

ARTICLE 49

- 1 The buyer may declare the contract avoided:
 - a if the failure by the seller to perform any of his obligations under the contract or this Convention amounts to a fundamental breach of contract; or
 - b in case of non-delivery, if the seller does not deliver the goods within the additional period of time fixed by the buyer in accordance with paragraph (1) of article 47 or declares that he will not deliver within the period so fixed.
- 2 However, in cases where the seller has delivered the goods, the buyer loses the right to declare the contract avoided unless he does so:
 - a in respect of late delivery, within a reasonable time after he has become aware that delivery has been made;
 - b in respect of any breach other than late delivery, within a reasonable time:
 - i after he knew or ought to have known of the breach;
 - ii after the expiration of any additional period of time fixed by the buyer in accordance with paragraph (1) of article 47, or after the seller has declared that he will not perform his obligations within such an additional period; or
 - iii after the expiration of any additional period of time indicated by the seller in accordance with paragraph (2) of article 48, or after the buyer has declared that he will not accept performance.

ARTICLE 50

If the goods do not conform with the contract and whether or not the price has already been paid, the buyer may reduce the price in the same proportion as the value that the goods actually delivered had at the time of the delivery bears to the value that conforming goods would have had at that time. However, if the seller remedies any failure to perform his obligations in accordance with article 37 or article 48 or if the buyer refuses to accept performance by the seller in accordance with those articles, the buyer may not reduce the price.

ARTICLE 51

- 1 If the seller delivers only a part of the goods or if only a part of the goods delivered is in conformity with the contract, articles 46 to 50 apply in respect of the part which is missing or which does not conform.
- 2 The buyer may declare the contract avoided in its entirety only if the failure to make delivery completely or in conformity with the contract amounts to a fundamental breach of the contract.

ARTICLE 52

- 1 If the seller delivers the goods before the date fixed, the buyer may take delivery or refuse to take delivery.
- 2 If the seller delivers a quantity of goods greater than that provided for in the contract, the buyer may take delivery or refuse to take delivery of the excess quantity. If the buyer takes delivery of all or part of the excess quantity, he must pay for it at the contract rate.

Chapter III: Obligations of the Buyer

ARTICLE 53

The buyer must pay the price for the goods and take delivery of them as required by the contract and this Convention.

Section 1: Payment of the Price

ARTICLE 54

The buyer's obligation to pay the price includes taking such steps and complying with such formalities as may be required under the contract or any laws and regulations to enable payment to be made.

ARTICLE 55

Where a contract has been validly concluded but does not expressly or implicitly fix or make provision for determining the price, the parties are considered, in the absence of any indication to the contrary, to have impliedly made reference to the price generally charged at the time of the conclusion of the contract for such goods sold under comparable circumstances in the trade concerned.

ARTICLE 56

If the price is fixed according to the weight of the goods, in case of doubt it is to be determined by the net weight.

ARTICLE 57

- 1 If the buyer is not bound to pay the price at any other particular place, he must pay it to the seller:
 - a at the seller's place of business; or
 - b if the payment is to be made against the handing over of the goods or of documents, at the place where the handing over takes place.
- 2 The seller must bear any increase in the expenses incidental to payment which is caused by a change in his place of business subsequent to the conclusion of the contract.

ARTICLE 58

- 1 If the buyer is not bound to pay the price at any other specific time, he must pay it when the seller places either the goods or documents controlling their disposition at the buyer's disposal in accordance with the contract and this Convention. The seller may make such payment a condition for handing over the goods or documents.
- 2 If the contract involves carriage of the goods, the seller may dispatch the goods on terms whereby the goods, or documents controlling their disposition, will not be handed over to the buyer except against payment of the price.
- 3 The buyer is not bound to pay the price until he has had an opportunity to examine the goods, unless
- 4 the procedures for delivery or payment agreed upon by the parties are inconsistent with his having such an opportunity.

ARTICLE 59

The buyer must pay the price on the date fixed by or determinable from the contract and this Convention without the need for any request or compliance with any formality on the part of the seller.

APPENDIX

Section H: Taking delivery

ARTICLE 60

The buyer's obligation to take delivery consists:

- a in doing all the acts which could reasonably be expected of him in order to enable the seller to make delivery; and
- b in taking over the goods.

Section I: Remedies for Breach of Contract by the Buyer

ARTICLE 61

- 1 If the buyer fails to perform any of his obligations under the contract or this Convention, the seller may:
 - a exercise the rights provided in articles 62 to 65;
 - b claim damages as provided in articles 74 to 77.
- 2 The seller is not deprived of any right he may have to claim damages by exercising his right to other remedies.
- 3 No period of grace may be granted to the buyer by a court or arbitral tribunal when the seller resorts to a remedy for breach of contract.

ARTICLE 62

The seller may require the buyer to pay the price, take delivery or perform his other obligations, unless the seller has resorted to a remedy which is inconsistent with this requirement.

ARTICLE 63

- 1 The seller may fix an additional period of time of reasonable length for performance by the buyer of his obligations.
- 2 Unless the seller has received notice from the buyer that he will not perform within the period so fixed, the seller may not, during that period, resort to any remedy for breach of contract. However, the seller is not deprived thereby of any right he may have to claim damages for delay in performance.

ARTICLE 64

- 1 The seller may declare the contract avoided:
 - a if the failure by the buyer to perform any of his obligations under the contract or this Convention amounts to a fundamental breach of contract; or
 - b if the buyer does not, within the additional period of time fixed by the seller in accordance with paragraph (1) of article 63, perform his obligation to pay the price or take delivery of the goods, or if he declares that he will not do so within the period so fixed.
- 2 However, in cases where the buyer has paid the price, the seller loses the right to declare the contract avoided unless he does so:
 - a in respect of late performance by the buyer, before the seller has become aware that performance has been rendered; or
 - b in respect of any breach other than late performance by the buyer, within a reasonable time:

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- i after the seller knew or ought to have known of the breach; or
- ii after the expiration of any additional period of time fixed by the seller in accordance with paragraph (1) of article 63, or after the buyer has declared that he will not perform his obligations within such an additional period.

ARTICLE 65

- 1 If under the contract the buyer is to specify the form, measurement or other features of the goods and he *fails* to make such specification either on the date agreed upon or within a reasonable time after receipt of a request from the seller, the seller may, without prejudice to any other rights he may have, make the specification himself in accordance with the requirements of the buyer that may be known to him.
- 2 If the seller makes the specification himself, he must inform the buyer of the details thereof and must fix a reasonable time within which the buyer may make a different specification. If, after receipt of such a communication, the buyer fails to do so within the time so fixed, the specification made by the seller is binding.

Chapter IV: Passing of Risk

ARTICLE 66

Loss of or damage to the goods after the risk has passed to the buyer does not discharge him from his obligation to pay the price, unless the loss or damage is due to an act or omission of the seller.

ARTICLE 67

- 1 If the contract of sale involves carriage of the goods and the seller is not bound to hand them over at a particular place, the risk passes to the buyer when the goods are handed over to the first carrier for transmission to the buyer in accordance with the contract of sale. If the seller is bound to hand the goods over to a carrier at a particular place, the risk does not pass to the buyer until the goods are handed over to the carrier at that place. The fact that the seller is authorized to retain documents controlling the disposition of the goods does not affect the passage of the risk.
- 2 Nevertheless, the risk does not pass to the buyer until the goods are clearly identified to the contract, whether by markings on the goods, by shipping documents, by notice given to the buyer or otherwise.

ARTICLE 68

The risk in respect of goods sold in transit passes to the buyer from the time of the conclusion of the contract. However, if the circumstances so indicate, the risk is assumed by the buyer from the time the goods were handed over to the carrier who issued the documents embodying the contract of carriage. Nevertheless, if at the time of the conclusion of the contract of sale the seller knew or ought to have known that the goods had been lost or damaged and did not disclose this to the buyer, the loss or damage is at the risk of the seller.

ARTICLE 69

- 1 In cases not within articles 67 and 68, the risk passes to the buyer when he takes over the goods or, if he does not do so in due time, from the time when the goods are placed at his disposal and he commits a breach of contract by failing to take delivery.
- 2 However, if the buyer is bound to take over the goods at a place other than a place of business of the seller, the risk passes when delivery is due and the buyer is aware of the fact that the goods are placed at his disposal at that place.

APPENDIX

- 3 If the contract relates to goods not then identified, the goods are considered not to be placed at the disposal of the buyer until they are clearly identified to the contract.

ARTICLE 70

If the seller had committed a fundamental breach of contract, articles 67, 68 and 69 do not impair the remedies available to the buyer on account of the breach.

Chapter V: Provisions Common to the Obligations of the Seller and of the Buyer

Section 1: Anticipatory Breach and Installment Contracts

ARTICLE 71

- 1 A party may suspend the performance of his obligations if, after the conclusion of the contract, it becomes apparent that the other party will not perform a substantial part of his obligations as a result of:
 - a a serious deficiency in his ability to perform or in his creditworthiness; or
 - b his conduct in preparing to perform or in performing the contract.
- 2 If the seller has already dispatched the goods before the grounds described in the preceding paragraph become evident, he may prevent the handing over of the goods to the buyer even though the buyer holds a document which entitles him to obtain them. The present paragraph relates only to the rights in the goods as between the buyer and the seller.
- 3 A party suspending performance, whether before or after dispatch of the goods must immediately give notice of the suspension to the other party and must continue with performance if the other party provides adequate assurance of his performance.

ARTICLE 72

- 1 If prior to the date for performance of the contract it is clear that one of the parties will commit a fundamental breach of contract, the other party may declare the contract avoided.
- 2 If time allows, the party intending to declare the contract avoided must give reasonable notice to the other party in order to permit him to provide adequate assurance of his performance.
- 3 The requirements of the preceding paragraph do not apply if the other party has declared that he will not perform his obligations.

ARTICLE 73

- 1 In the case of a contract for delivery of goods by installments, if the failure of one party to perform any of his obligations in respect of any installment constitutes a fundamental breach of contract with respect to that installment, the other party may declare the contract avoided with respect to that installment.
- 2 If one party's failure to perform any of his obligations in respect of any installment gives the other party good grounds to conclude that a fundamental breach of contract will occur with respect to future installments, he may declare the contract avoided for the future, provided that he does so within a reasonable time.
- 3 A buyer who declares the contract avoided in respect of any delivery may, at the same time, declare it avoided in respect of deliveries already made or of future deliveries if, by reason of their interdependence, those deliveries could not be used for the purpose contemplated by the parties at the time of the conclusion of the contract.

Section VI: Damages

ARTICLE 74

Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract.

ARTICLE 75

If the contract is avoided and if, in a reasonable manner and within a reasonable time after avoidance, the buyer has bought goods in replacement or the seller has resold the goods, the party claiming damages may recover the difference between the contract price and the price in the substitute transaction as well as any further damages recoverable under article 74.

ARTICLE 76

- 1 If the contract is avoided and there is a current price for the goods, the party claiming damages may, if he has not made a purchase or resale under article 75, recover the difference between the price fixed by the contract and the current price at the time of avoidance as well as any further damages recoverable under article 74. If, however, the party claiming damages has avoided the contract after taking over the goods, the current price at the time of such taking over shall be applied instead of the current price at the time of avoidance.
- 2 For the purposes of the preceding paragraph, the current price is the price prevailing at the place where delivery of the goods should have been made or, if there is no current price at that place, the price at such other place as serves as a reasonable substitute, making due allowance for differences in the cost of transporting the goods.

ARTICLE 77

A party who relies on a breach of contract must take such measures as are reasonable in the circumstances to mitigate the loss, including loss of profit, resulting from the breach. If he fails to take such measures, the party in breach may claim a reduction in the damages in the amount by which the loss should have been mitigated.

ARTICLE 78

If a party fails to pay the price or any other sum that is in arrears, the other party is entitled to interest on it, without prejudice to any claim for damages recoverable under article 74.

Section IV: Exemptions

ARTICLE 79

- 1 A party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.
- 2 If the party's failure is due to the failure by a third person whom he has engaged to perform the whole or a part of the contract, that party is exempt from liability only if:
 - a he is exempt under the preceding paragraph; and
 - b the person whom he has so engaged would be so exempt if the provisions of that paragraph were applied to him.

APPENDIX

- 3 The exemption provided by this article has effect for the period during which the impediment exists.
- 4 The party who fails to perform must give notice to the other party of the impediment and its effects on his ability to perform. If the notice is not received by the other party within a reasonable time after the party who fails to perform knew or ought to have known of the impediment, he is liable for damages resulting from such non-receipt.
- 5 Nothing in this article prevents either party from exercising any right other than to claim damages under this Convention.

ARTICLE 80

A party may not rely on a failure of the other party to perform, to the extent that such failure was caused by the first party's act or omission.

Section V: Effects of Avoidance

ARTICLE 81

- 1 Avoidance of the contract releases both parties from their obligations under it, subject to any damages which may be due. Avoidance does not affect any provision of the contract for the settlement of disputes or any other provision of the contract governing the rights and obligations of the parties consequent upon the avoidance of the contract.
- 2 A party who has performed the contract either wholly or in part may claim restitution from the other party of whatever the first party has supplied or paid under the contract. If both parties are bound to make restitution, they must do so concurrently.

ARTICLE 82

- 1 The buyer loses the right to declare the contract avoided or to require the seller to deliver substitute goods if it is impossible for him to make restitution of the goods substantially in the condition in which he received them.
- 2 The preceding paragraph does not apply:
 - a if the impossibility of making restitution of the goods or of making restitution of the goods substantially in the condition in which the buyer received them is not due to his act or omission;
 - b if the goods or part of the goods have perished or deteriorated as a result of the examination provided for in article 38; or if the goods or part of the goods have been sold in the normal course of business or have been consumed or transformed by the buyer in the course of normal use before he discovered or ought to have discovered the lack of conformity.

ARTICLE 83

A buyer who has lost the right to declare the contract avoided or to require the seller to deliver substitute goods in accordance with article 82 retains all other remedies under the contract and this Convention.

ARTICLE 84

- 1 If the seller is bound to refund the price, he must also pay interest on it, from the date on which the price was paid.
- 2 The buyer must account to the seller for all benefits which he has derived from the goods or part of them:
 - a if he must make restitution of the goods or part of them; or
 - b if it is impossible for him to make restitution of all or part of the goods or to make restitution of all or part of the goods substantially in the condition in which he received them, but he has nevertheless declared the contract avoided or required the seller to deliver substitute goods.

Section VI: Preservation of the Goods

ARTICLE 85

If the buyer is in delay in taking delivery of the goods or, where payment of the price and delivery of the goods are to be made concurrently, if he *fails* to pay the price, and the seller is either in possession of the goods or otherwise able to control their disposition, the seller must take such steps as are reasonable in the circumstances to preserve them. He is entitled to retain them until he has been reimbursed his reasonable expenses by the buyer.

ARTICLE 86

- 1 If the buyer has received the goods and intends to exercise any right under the contract or this Convention to reject them, he must take such steps to preserve them as are reasonable in the circumstances. He is entitled to retain them until he has been reimbursed his reasonable expenses by the seller.
- 2 If goods dispatched to the buyer have been placed at his disposal at their destination and he exercises the right to reject them, he must take possession of them on behalf of the seller, provided that this can be done without payment of the price and without unreasonable inconvenience or unreasonable expense. This provision does not apply if the seller or a person authorized to take charge of the goods on his behalf is present at the destination. If the buyer takes possession of the goods under this paragraph, his rights and obligations are governed by the preceding paragraph.

ARTICLE 87

A party who is bound to take steps to preserve the goods may deposit them in a warehouse of a third person at the expense of the other party provided that the expense incurred is not unreasonable.

ARTICLE 88

- 1 A party who is bound to preserve the goods in accordance with article 85 or 86 may sell them by any appropriate means if there has been an unreasonable delay by the other party in taking possession of the goods or in taking them back or in paying the price or the cost of preservation, provided that reasonable notice of the intention to sell has been given to the other party.
- 2 If the goods are subject to rapid deterioration or their preservation would involve unreasonable expense, a party who is bound to preserve the goods in accordance with article 85 or 86 must take reasonable measures to sell them. To the extent possible he must give notice to the other party of his intention to sell.
- 3 A party selling the goods has the right to retain out of the proceeds of sale an amount equal to the reasonable expenses of preserving the goods and of selling them. He must account to the other party for the balance.

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